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Family loans and gifts: how to help without creating a tax headache

Helping a family member financially can be one of the most generous things you do. But when money changes hands between relatives, good intentions don't always prevent misunderstandings—or tax complications. The IRS treats gifts and loans very differently, and failing to document things properly can create unintended tax consequences.

So, is it better to give cash as a gift or structure it as a loan? And if you go the loan route, how do you ensure it holds up under IRS scrutiny? Let's break it down.

Gift or loan?

A gift is a transfer of money or property made with no expectation of repayment. Parents might contribute to a down payment on a child's first home or offer tuition support for college. Under federal gift tax rules, individuals can give up to a certain annual exclusion amount to each recipient before needing to worry about gift tax filings. In 2025, the annual exclusion is $19,000 for each individual. If you exceed this threshold, you'll have to use part of your lifetime gift tax exemption. While most people will not end up owing tax on such gifts, the paperwork burdens—and potential complexities around estate planning—make it important to track and document each gift.

A loan is different because it creates a creditor-debtor relationship. In other words, there is a clear expectation of repayment, along with potential interest that is legally enforceable. While lending money to a family member might feel too informal to require paperwork, documenting the loan with a promissory note is crucial. Documentation helps protect against the unexpected. For instance, what if you loan money to your married child, and they unexpectedly pass away? If the loan is undocumented, you may find yourself negotiating repayment with their spouse - who may have different priorities or simply refuse to pay. Likewise, if anything happens to you and the loan isn't documented, it may cause disputes between your heirs.

And, perhaps, most importantly, documentation may help you in the event of IRS scrutiny.

IRS guidelines and key tax considerations

The IRS pays close attention to family transactions, especially those that blur the line between an outright gift and a loan.

They don't necessarily scrutinize every small family loan, but they do pay attention when the loan amount is significant, no interest is charged or the rate is unrealistically low, or there's no formal documentation, making it look like a disguised gift.

If the loan terms don't meet IRS standards, they may impute interest based on the Applicable Federal Rate known as the AFR. The AFR generally comes in three variations (short, mid, and long-term) based on how many years the loan is expected to last. If you don't charge at least the AFR for interest, the IRS may impute interest - meaning they'll treat you as though you received interest income, even if no interest payments were made. This imputed interest is considered taxable income.

The IRS may also recharacterize the loan as a gift, potentially requiring a gift tax return and reducing your lifetime exemption.

Income tax implications

As the lender, any interest you receive is ordinary income and must be reported on your tax return. If expectations fall through and the borrower defaults, you may be able to deduct the principal as a bad debt loss, but only if you can demonstrate that the loan was truly a bona fide transaction with no reasonable chance of recovering the funds through other means. This deduction would require solid documentation of the loan and any collection efforts. The borrower may also owe taxes on the canceled debt.

For borrowers, the interest paid on a family loan might be deductible in limited cases like educational loans, business loans, or when the loan is secured by a mortgage on a primary residence.

Structuring a valid family loan

Family loans can be a great way to provide financial support while offering flexibility that a traditional lender might not. But they also come with legal and tax complexities that shouldn't be overlooked. It's important to work with an experienced attorney to ensure the loan is properly structured and documented.

To avoid IRS scrutiny and preserve family relationships, treat the loan with the same level of seriousness as a traditional lender. Here are some basics to keep in mind:

Put it in writing

First, put it in writing. A loan agreement isn't just a formality - it protects both the lender and the borrower. Make sure you have a promissory note that clearly spells out the loan amount, interest rate, repayment schedule, and consequences of default.

Charge at least the AFR

Second, charge at least the AFR. The IRS updates this rate every month, and it varies based on the loan's length. If you don't charge at least this rate, it can create tax complications.

Keep records of payments

Ensure you document payments. Whether it's checks, bank transfers, or another method, you need to track every payment. And if payments stop, follow up in writing. A well-documented loan helps prove to both the IRS and your family that it was a legitimate transaction.

Consider collateral

And finally, consider securing the loan with collateral. If it's a significant amount, like a loan for a house or a car, having the loan backed by an asset can reinforce that this is a real financial agreement, not just an informal family favor.

Every family's situation is different, and the tax rules around family loans can be tricky. Before finalizing any family loan, sit down with a qualified attorney and tax advisor to ensure the arrangement is set up correctly and aligns with your long-term goals.

Strategic uses of family lending

When structured properly, family loans can serve as an effective wealth transfer strategy.

Helping a loved one through financial hardship

If a relative is facing unexpected medical bills, job loss, or another financial emergency, a loan can be a lifeline. If the amount is under $10,000, the IRS generally won't require you to charge interest. But it's still a good idea to document the arrangement.

Funding a child's education

Parents who want to assist with college tuition without gifting the money can structure a family loan with flexible repayment terms. In some cases, interest paid on educational loans may be tax-deductible for the borrower, provided it meets IRS requirements.

Assisting with a home purchase

Family mortgages are common when traditional bank financing isn't an option. If structured properly, including filing the appropriate mortgage documents, the borrower may even be able to deduct the interest on their tax return. Plus, if interest rates drop, the loan can be refinanced at a new AFR.

Shifting investment growth out of your estate

For families with significant wealth that may trigger estate taxes, intrafamily loans can be a way to transfer assets tax-efficiently. If a parent lends money at the AFR and the child invests it at a higher return, the growth above the loan's interest cost belongs to the child - without using the parent's lifetime gift tax exemption.

While this strategy doesn’t directly benefit the lender from a tax perspective, it allows heirs to leverage family wealth to pursue investment opportunities and capture returns that would otherwise remain within the parent’s taxable estate.

Tread carefully

Lending money to family can be a meaningful way to provide support, but it needs to be handled carefully. The key is documenting everything and ensuring a loan is treated like a loan.

Next Step

If you're considering a significant gift or loan to a relative, it's always wise to consult with a tax professional and attorney to ensure everything is structured correctly. For personalized guidance, please contact our office.

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