Is now the right time to forgive intrafamily loans?

Whether you made intrafamily loans years ago or perhaps this year in response to a loved one's financial troubles due to the COVID-19 pandemic, consider forgiving those loans. Why? A record-high gift and estate tax exemption amount and a low-interest-rate environment add up to an ideal time to forgive intrafamily loans.

Under the right circumstances, an intrafamily loan can be a powerful estate planning tool because it allows you to transfer wealth to your loved ones free of gift or generation-skipping transfer (GST) taxes — to the extent the loan proceeds achieve a certain level of returns.

Intrafamily loan wild card: Interest rates

Generally, to ensure the desired tax outcome, an intrafamily loan must have an interest rate that equals or exceeds the applicable federal rate (AFR) at the time the loan is made. The principal and interest are included in the lender's estate, so the key to transferring wealth tax-free is for the borrower to invest the loan proceeds in a business, real estate or another opportunity whose returns outperform the AFR.

The excess of these investment returns over the interest expense is essentially a tax-free gift to the borrower. Intrafamily loans work best in a low-interest-rate environment, when it's easier to outperform the AFR.

Reasons to forgive a loan

An intrafamily loan is an attractive estate planning tool if you've already used up your gift tax exemption or if you wish to save it for future transfers. But if you have exemption to spare, forgiving an intrafamily loan allows you to transfer the entire loan principal plus any accrued interest tax-free, not just the excess of the borrower's returns over the AFR.

Forgiving a loan can be a strategy for taking advantage of the current $11.58 million ($23.16 million for married couples filing jointly) exemption amount before it's scheduled to disappear at the end of 2025, when the amount reverts to $5 million ($10 million for married couples), indexed for inflation. Of course, if you need the funds for your own living expenses, loan forgiveness may not be an option.

Income tax considerations

Before you forgive an intrafamily loan, consider any potential income tax issues for you and the borrower. In most cases, forgiving a loan to a loved one is considered a gift, which generally has no income tax consequences for either party.

Although forgiveness of a loan sometimes results in cancellation of debt (COD) income to the borrower, the tax code recognizes an exception for debts canceled as a "gift, bequest, devise or inheritance." There's also an exception for a borrower who's insolvent at the time the debt is forgiven. But be careful: If there's evidence that forgiving a loan is not intended as a gift, the IRS may argue that the borrower has COD income.

One thing you should avoid is forgiving accrued interest on an intrafamily loan *every* year. Doing so may give the IRS ammunition to argue that the *original* loan was a disguised gift, which can trigger gift taxes, depending on the exemption amount in the year the loan was made.

Turn to your trusted advisor

Forgiving outstanding intrafamily loans in today's low-interest-rate loan environment, coupled with the record-high gift and estate tax exemption and the GST tax exemption, may be a beneficial strategy for you. Your estate planning advisor can help in implementing that strategy without triggering unwanted tax consequences.

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