Now may be the time to forgive intrafamily loans

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If you have outstanding loans to your children, grandchildren or other family members, consider forgiving those loans to take advantage of the current, record-high $11.58 million gift and estate tax exemption. Be advised that in 2026, the exemption amount will revert to $5 million ($10 million for married couples), indexed for inflation.

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 taxes — to the extent the loan proceeds achieve a certain level of returns. But an outright gift is a far more effective way to transfer wealth, provided you don't need the interest income and have enough unused exemption to shield it from transfer taxes.

Do intrafamily loans save taxes?

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 other 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.

Why forgive a loan?

An intrafamily loan is an attractive estate planning tool if you've already used up your 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.

It can be a strategy for taking advantage of the increased exemption amount before it disappears at the end of 2025. Of course, if you need the funds for your own living expenses, loan forgiveness may not be an option.

What about income taxes?

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 isn't intended as a gift — for example, if the borrower doesn't have the cash needed to make the loan payments but isn't technically insolvent — the IRS may argue that the borrower has COD income.

We can assist you in determining whether forgiving loans is a good strategy and, if it is, help implement that strategy without triggering unwanted tax consequences.

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