Making an intrafamily loan “bona fide” to avoid gift tax

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The simplest way to provide financial assistance to a child or other family member is to get out your checkbook and make a gift. But if you’re concerned about gift taxes, a loan may be preferable. Intrafamily loans must be structured and managed carefully to ensure that the IRS will treat them as bona fide loans rather than disguised gifts.

Factors to determine loan legitimacy

Here are some factors the IRS considers when determining if a loan between related parties is legitimate:

- Existence of a promissory note or other instrument;
- Payment of a reasonable rate of interest;
- A fixed repayment schedule;
- Adequate collateral or other security;
- Actual repayment of the loan;
- Whether, at the time the loan was made, the borrower had a reasonable prospect of repaying the loan and the lender had sufficient funds to make the advance; and
- The conduct of the parties.

The last factor is a catch-all that encompasses one of the distinguishing characteristics of a bona fide loan: the parties’ intention that the money advanced will be repaid. An examination of the first six factors may reveal conduct that’s inconsistent with a loan, such as failure to execute a promissory note or to repay the loan. However, other conduct may also indicate the lack of a debtor-creditor relationship, such as executing a promissory note after the fact or the lender’s failure to make reasonable collection efforts.

Proper documentation required

If you treat the transaction like a “real” loan, it’s more likely that the IRS will treat it as a loan as well. If you wish to make a loan to a loved one, we can help ensure it’s properly documented to pass IRS muster.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com