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MONEY NOTES

## Love and Lending: The Intrafamily Loan Explained

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Few financial conversations carry as much emotional weight as those that happen inside a family. More families are turning to intrafamily loans and outright gifts as deliberate wealth transfer tools, moving capital where it is needed most. The core question is always the same - loan or gift? They are not the same thing, and treating one like the other can create unwanted tax exposure and potential familial strife. What matters is understanding the rules, the risks, and the relationship dynamics before any money changes hands.

The same considerations apply regardless of which direction support flows. Parents lending to adult children face the same IRS rules as adult children stepping in to help an aging parent. This article addresses both.

### What Is an Intrafamily Loan?

An intrafamily loan is a formal arrangement between family members - structured with a defined interest rate, a repayment schedule, and a written agreement - as opposed to an outright gift, which carries no expectation of repayment. Common uses vary by generation:

- Residence down payment or mortgage paydown
- Seed capital for a business or investment portfolio
- Consolidating high-interest debt
- Education costs that are not covered by savings
- Long-term care or medical expenses
- Home modifications for [aging in place](#)
- Bridging cash flow before an asset is sold
- Avoiding forced liquidation at the wrong time

A transfer can go directly to an individual or to a family trust, each with different implications for control, creditor protection, and estate planning.

### The Tax Rules Behind Intrafamily Loans

The Applicable Federal Rate (AFR) is the IRS-published minimum interest rate required on a family loan to avoid reclassification as a gift. It varies by term and is updated monthly at [irs.gov](https://www.irs.gov):

- **Short-term:** three years or less
- **Mid-term:** more than three years, less than nine years
- **Long-term:** nine years or more

When a loan charges no interest or interest below the AFR, the IRS may impute interest income to the lender and simultaneously treat the forgone amount as a taxable gift. This is one of the most common and entirely avoidable missteps in family lending. Interest received by the lender is taxable income; whether the borrower can deduct it depends on how the funds are used - mortgage, investment, and business interest are each treated differently.

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*Specific tax outcomes vary widely by individual circumstance. Before any family loan or gift of meaningful size is made, a qualified tax advisor or estate planning attorney should be part of the conversation.*

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## Why a Formal Loan Agreement Is Worth the Paperwork

An undocumented arrangement is the easiest thing for the IRS to reclassify as a taxable gift - and just as easy to become the source of a family dispute over what was actually agreed upon. A written loan agreement is not bureaucratic overreach; it is how you protect the arrangement, the relationship, and everyone involved.

A sound family loan agreement should include:

- Principal amount
- Interest rate at or above the AFR
- Repayment schedule
- Maturity or balloon terms
- Prepayment rights
- Provisions for default or the lender's death

When helping a parent, documentation matters even more. Undocumented transfers can complicate Medicaid eligibility under the look-back rules<sup>1</sup>, create ambiguity in the parent's estate, and invite conflict among heirs. Coordinating with an elder law attorney is strongly advisable when Medicaid may eventually be a factor.

## Loan or Gift? Weighing Both Options

The IRS distinguishes a loan from a gift based on documentation and behavior, not intent. A loan requires an expectation of repayment and interest at or above the AFR. A gift carries no repayment obligation. An 'informal loan' without written terms or payment history will likely be treated as a gift - with all the tax consequences that follow.

|             | Intrafamily Loan                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                          | Outright Gift                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|-------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Pros</b> | <ul style="list-style-type: none"> <li>• Moves money without using the annual gift exclusion or lifetime exemption</li> <li>• Future growth on the funds can pass to the next generation outside the lender's estate</li> <li>• Interest can be set at the low Applicable Federal Rate (AFR), well below bank rates</li> <li>• Preserves the lender's capital as the funds are repaid, not given away</li> <li>• Builds financial discipline and accountability in the borrower</li> <li>• More flexible than a bank: no credit check, no income verification, adjustable schedule</li> <li>• Can help equalize an inheritance if reflected in the estate plan</li> </ul> | <ul style="list-style-type: none"> <li>• Simple with no loan agreement, interest, or repayment tracking to manage</li> <li>• Up to the annual exclusion (\$19,000 per recipient in 2025/2026<sup>2</sup>) passes with no gift tax and no lifetime-exemption use</li> <li>• No imputed interest and no taxable interest income to report</li> <li>• No repayment pressure, so less risk of relationship strain over collecting payments</li> <li>• Immediate, unconditional help that is useful for an aging parent's care or a child's urgent need</li> </ul> |
| <b>Cons</b> | <ul style="list-style-type: none"> <li>• Requires a formal agreement, an AFR-based rate, and ongoing recordkeeping</li> <li>• Interest received is taxable income to the lender</li> <li>• Below-market or forgiven interest can trigger imputed-interest and gift-tax issues</li> <li>• Missed, paused, or renegotiated payments can strain the relationship</li> <li>• Perceived unfairness among family members if terms differ from one to the next</li> <li>• Creates a repayment obligation for the borrower</li> </ul>                                                                                                                                             | <ul style="list-style-type: none"> <li>• Amounts above the annual exclusion draw down the lifetime exemption (or trigger gift tax)</li> <li>• The funds and their future growth leave the giver's estate permanently</li> <li>• Larger gifts require filing a gift tax return (Form 709)</li> <li>• Less opportunity to teach financial accountability</li> <li>• Once given, the giver has no claim to the money if their own circumstances change</li> <li>• Nonpayment could impact family relationships</li> </ul>                                        |

A hybrid path also exists: a loan can be partially forgiven over time, with each annual forgiveness treated as a gift within the exclusion. This must be handled carefully - if the arrangement appears to have been a gift from the start, the IRS may recharacterize the entire transfer.

## Questions to Ask Before Moving Forward

Once the tax rules and documentation requirements are clear, the next step is deciding whether an intrafamily loan or gift makes sense for your family in practical terms. A transfer may work well on paper and still create strain in real life. Before lending money to family - or making a substantial gift to a family member - it is important to think through not only the financial impact, but also the expectations and emotions that may come with it.

- Can the lender or giver comfortably afford it?
- Is repayment realistic?
- Are expectations clearly understood?
- How will other family members react?
- Does the arrangement fit the broader estate plan?

Money rarely damages family relationships on its own. More often, the problem is uncertainty - about repayment, fairness, or intent. Asking the right questions before moving forward can help families approach an intrafamily loan or gift with greater clarity, stronger communication, and a better chance of preserving both wealth and relationships.

## Moving Forward with the Right Guidance

Whether the right answer is an intrafamily loan or an outright gift, the structure matters. Before money changes hands, families should make sure the arrangement fits their broader financial plan, estate strategy, and tax picture. The right guidance can help clarify not only how to structure the transfer, but whether it should happen at all.

- Your **BLBB wealth advisor** to assess the planning, estate implications, and serve as quarterback of your professional team
- A **tax professional** to address income and gift tax questions
- An **estate planning attorney** to draft or review the agreement
- An **elder law attorney** when Medicaid or long-term care planning is involved

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<sup>1</sup> <https://www.medicaidplanningassistance.org/medicaid-look-back-period/>

<sup>2</sup> <https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax>

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L to R: Robb Parlanti, Laura LaRosa, Clif Haugen, John Lawton, Laura Brewer, Dean Karrash, Brian Gallagher, Brianna March, Nick Buccu, Bob Flood, Mike Geraghty, Zack Renna, Lisa Broome

