Key Private Bank

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Using Intrafamily Loans to Take Advantage of Low Rates

By the Key Wealth Institute

When properly structured, an intrafamily loan can help the borrower achieve important life goals and provide the family with an excellent wealth transfer planning tool.

Families can loan money to a family member for various purposes, including purchasing a residence and making an investment. However, this strategy requires the consideration of critical factors and a complete understanding of the unique dynamics involved before employing this strategy.

Not a Gift, But a Family Loan – Outlining the Strategy

Intrafamily loans can be an attractive strategy for a family member who is unconcerned about the cash flow received from the loan and would like to loan money at favorable rates to younger generations. Specific guidelines must be followed to avoid having the loan considered a gift for tax purposes. These guidelines can include charging a minimum interest rate, documenting the loan, and establishing a repayment structure.

Intrafamily loans typically use the Applicable Federal Rate (AFR), the lowest interest rate that can be charged on a loan, so the IRS does not consider it a gift. Gift loans are made using interest rates at below-market rates-- a rate less than the AFR.

To see how an intrafamily loan works, consider the following example. Tom and Cindy have a daughter Mary who is a real estate agent. Mary has a mortgage balance of about $450,000, and it's difficult for her to make payments in months when her commissions are low. Her parents can pay the mortgage in full and create a $450,000 promissory note (intrafamily loan) for Mary with a long-term AFR of 1.46% (February 2021 rates).

If Tom and Cindy forgive $15,000 per year ($30,000 total per year) of principal and interest, the promissory note would be paid in full in a little under 17 years. Any forgiveness must not appear to be a prearranged agreement to forgive interest or principal payments to avoid concerns that the entire loan may be a taxable gift.

This strategy allows the parents to replace their daughter's required monthly mortgage payment with more-advantageous intrafamily loan repayment. It also addresses their desire to not use any of their applicable gift tax exclusion amount by having each forgive $15,000 per year for a total of $30,000 per year (the amount of the annual gift tax exclusion).

"There are many tools in the bag of any good estate planner, one of which is the intrafamily loan. Most planners will recommend this option, depending on a family's internal dynamics and the liquidity needs of the patriarch/matriarch."

-- David E. Redding, CTFA, AEP, "Intrafamily Loans: The Good, the Bad and the Ugly." Kiplinger, March 3, 2020.[1]

The Power of Intrafamily Loans

Intrafamily loans can provide liquidity for the next generation and accelerate the achievement of goals. The current low AFR rates offer families an excellent opportunity to transfer wealth without having it characterized as a gift loan and utilizing the lifetime gift tax exclusion.

Using Intrafamily Loans to Take Advantage of Low Rates

As an article in The National Law Review ("Intrafamily Loans, August 17, 2020) notes, families "with existing promissory notes may benefit from these record-low interest rates through a note refinance. If the terms of the original loan permit a prepayment of the promissory note at any time without penalty, then the lender may be able to reissue a replacement promissory note that takes advantage of that lower interest rate."[2]

Safeguarding the Family Dynamic

Intrafamily loans aren't without their obstacles, as noted by Peter Lazaroff in the Forbes article "What You Should Consider Before Entering An Intrafamily Loan" (January 17, 2021). The family dynamic may be impacted, and it's critical to consider how the lending agreement may affect the relationship between parents, children, and other family members. Lazaroth recommended a few strategies to ensure that an intrafamily loan goes off smoothly[3]:

1.Work toward fairness. Intrafamily loans may create relationship problems among siblings when disbursement isn't equal. Also, one child may become dependent on loans to cover ongoing living expenses, and animosity may arise if not all children are borrowers. That makes it essential that lenders are careful when discussing and structuring terms to ensure that the arrangement won't lead to relationship issues later.

2. Weigh the repercussions of delinquency or default. Family lenders must consider if their financial situation will be jeopardized if the borrower cannot continue making loan payments. They must also anticipate what would happen if the borrower defaults on the loan and a gift tax for the year is potentially triggered. Due to the tax regulations associated with defaulted loans and debt forgiveness, it is advisable to meet with a certified public accountant or tax advisor before establishing the lending agreement.

3. Create a paper (or digital) trail. Documentation of an intrafamily loan is essential for both the borrower and lender. For example, in an intrafamily home loan, documentation allows the individual to deduct the interest expense on income taxes. This documentation is also crucial for the lenders, who will need to quantify the interest income when filing taxes. Failure to do so could result in a reclassification of the loan as a gift by the IRS and trigger a gift tax for the lender. Again, a certified public accountant or tax advisor should be consulted to avoid any loan-related misunderstandings and ensure all aspects of the loan are documented.

For more information, please contact your Key Private Bank Advisor.

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Sources:

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2 - https://www.natlawreview.com/article/intrafamily-loans
3 - https://www.forbes.com/sites/peterlazaroff/2021/01/17/what-you-should-consider-before-entering-an-intrafamily-loan/