Intra-Family Loans: Options for Friendly Terms in a Rising-Rate Environment

Intra-family loans can be a convenient, low-cost option to provide financial assistance to family members in a rising-rate environment. It may seem as if lending within the family can be a casual affair, but those who explore the option should be sure they are taking the right steps to create a "win-win" scenario and avoid any tax pitfalls.

The benefits are clear. Intra-family loans can be made with below-market interest rates at the applicable federal rate (AFR), which is a rate set monthly by the IRS for certain loans. As of March 2024 the rates for annually compounding short-term loans (up to three years) were 4.71%; for mid-term loans (up to nine years), they were 4.13%; and long-term rates (for loans over nine years) were 4.40% (visit the IRS website at https://www.irs.gov/applicable-federal-rates for updated rates each month). This can be a significant savings compared to the prime interest rate, which is the basis for most personal bank loans, and which was 8.50% as of February 13, 2024. This is also a significant savings over commercial mortgage rates, which are now eclipsing 6.6% - 7.0%.

With rising interest rates, some families may be tempted to make transfers without charging any interest at all. Unfortunately, loans made with interest below the AFR are viewed by the IRS as gifts. Those gifts are subject to the federal gift tax, with a 40% rate, and in some states, state-level gift taxes, and could also generate penalties for failure to file paperwork documenting that the gift had been made. An individual's annual exclusion for gifts (currently $18,000 per gift) can offset the potential liability, as can use of the lifetime gift tax exemption.

The lesson is that families should document loans and use the correct minimum rate. Otherwise, an exciting opportunity could turn into a tax liability. Here are three steps for ensuring an intra-family loan provides the intended relief:

1. Do it by the book

If transfers are not formally established as loans, the IRS will recognize them as a different kind of transfer and will tax them accordingly. Have a professional draft the loan and use the correct applicable federal rate depending on the duration of the loan or other features, such as the right to force payment early or draw down the note like a line of credit. The AFR is different for each term range and - just as with a conventional loan - any arrangement that includes variable rates will fluctuate alongside national rates.

2. Investigate creative loan options

There are opportunities to be creative with loan structures to best suit a borrower's need. For example, if an adult child is purchasing a home, parents can structure a "balloon note" that allows the borrower to pay only the interest for a set amount of time. As payments come due, parents can use part of their annual gift tax exclusion amount to forgive parts of the loan. This minimizes - or potentially eliminates - the amount of interest the child pays. In addition, recording a mortgage using the note can allow the child to take tax deductions for any interest paid.

3. Make the most of existing trusts

Some trusts are designed to allow for flexible loan structures; owners should be familiar with the options available to them. A non-grantor trust, for example, provides the foundation for an interest-free loan. If the trustee agrees to loan a beneficiary money out of a trust, it can be done under highly advantageous terms.

Families can provide a welcome head start for major purchases or new ventures by using intra-family loans. By treating the loan vehicles as formal lending initiatives with the proper strategy and structure in place, families can capitalize on a timely, tax-friendly opportunity.

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