Intra-family loans:
Options for friendly terms abound in a low-rate environment

The low interest rate environment presents a number of opportunities to advantageously move assets between family members, including the currently popular practice of intra-family lending. 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 truly create a "win-win" scenario.

The benefits are clear. Intra-family loans can be made below market interest rates; that means in this historically low climate that borrowers may be looking at rates under 0.50%. As of July 2015, in fact, short term rates for annual lending were 0.48%, mid-term rates were 1.77%, and long term rates were 2.74% (for monthly IRS Applicable Federal Rates, visit the IRS website at http://apps.irs.gov/app/picklist/list/federalRates.html).

Even with such low rates available, some families may be tempted to make transfers without charging any interest at all. Unfortunately, those are viewed as gifts by the IRS and therefore treated as part of the grantor's annual gift tax exclusion ($14,000 per individual), and transfer amounts that exceed the exclusion are taxed at 40%.

The lesson is that families should apply AFR and follow the correct process. Otherwise, an exciting opportunity could turn into a tax liability. Here are three steps to 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, including whether it is short-term (up to 3 years), mid-term (3-9 years), or long term (9+ years). Rates are different for each term range and are based on the prime rate, so – 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 interest only 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 vastly minimizes the amount of interest the child pays and the amount of taxes the parents pay.

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.

When establishing a new trust, families should investigate these possibilities– although other factors carry more weight in structuring the right vehicle.

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