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Intrafamily Loans as a Planning Tool

An intrafamily loan can be a gratifying way to help a child or grandchild buy a home, start a business or pay down high-interest debt. These loans typically have superior terms and fewer underwriting requirements than a loan obtained through a commercial lender. Intrafamily loans can also be a compelling estate planning strategy. It is crucial, though, to make sure the loan is structured properly to avoid unexpected tax consequences.

Components of an Intrafamily Loan

Intrafamily loans are less formal than typical bank loans, but it is important to document the transaction in writing to reflect the intent that the transfer is a loan as opposed to a gift. Typically, this is in the form of a promissory note that includes the following key terms of the loan:

- Legal names of the lender and the borrower
- Date of the loan
- Loan amount
- Interest rate
- Length of the loan
- Structure of loan payments (monthly, annually, interest only or principal and interest)

You should consult an attorney to ensure the note is valid and legally enforceable in your state or jurisdiction.

The Applicable Federal Rate (AFR)

Lenders have significant flexibility when setting the terms of an intrafamily loan but must

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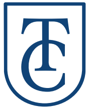

charge an interest rate equal to or greater than the Applicable Federal Rate (AFR). Failure to charge this minimum rate can result in the Internal Revenue Service (IRS) reclassifying the loan as a gift and can have unintended tax consequences for both the lender and the borrower.

The IRS publishes the AFRs each month on its website[1], and the rates vary depending on the duration of the loan and the period for compounding. The short-term rates apply to loans of three years or less, mid-term rates are for loans of up to nine years, and the long-term rates should be used for loans exceeding nine years. The IRS lets you use the current month's rates or the rates from either of the two prior months. Typically, the lender will choose to use the lowest permissible rate for the length of the loan, but this is not always the case.

Mortgage

With home prices and mortgage rates skyrocketing over the last few years, an intrafamily loan can be a strategy to help younger family members purchase a house. To qualify for the mortgage interest tax deduction, the loan must be secured by the house, and a deed of trust needs to be properly recorded under state law, giving the lender the right to foreclose on the property in the event of default.

Estate Planning Benefits

Intrafamily loans can also be a powerful estate planning tool for transferring wealth between generations without using up the lender's lifetime estate tax exemption. For example, assume a lender loans $5 million to a borrower, and the borrower reinvests the loan proceeds. The $5 million promissory note remains inside the lender's estate, but the appreciation on the reinvested proceeds is removed and occurs inside the borrower's estate. This strategy is a way to "freeze" a portion of the lender's estate and can be especially powerful when interest rates are low.

Tax Requirements

Interest income earned from an intrafamily loan is taxable to the lender and must be reported on the lender's tax return. There may also be reporting requirements for the borrower depending on the purpose of the loan and how the loan proceeds are used. Failure to follow all reporting requirements can result in penalties, so we encourage you to consult your tax preparer. Proper tax reporting can also serve as further evidence that the transaction is a loan and not a gift.

[1] https://www.irs.gov/applicable-federal-rates

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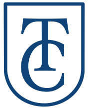

Conclusion

Intrafamily loans can be an effective planning strategy that benefits the entire family, but the tax rules are complex and can result in unintended consequences if the loan is not implemented correctly. It is always a good idea to consult your advisor team before executing an intrafamily loan to ensure it accomplishes the goals of all parties involved.

FOR MORE INFORMATION, PLEASE REACH OUT TO:

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