ROBERTSON STEPHENS®

July 25, 2022 – Wealth Planning Commentary

Intra-family loans, a powerful tool to empower heirs and transfer wealth

Last week the Wall Street Journal published an article on intra-family loans and there are a few comments and benefits to add. There are a couple of good reasons to write an intra-family loan: firstly, these loans are a great mechanism for parents or grandparents who are interested in helping their children or grandchildren and want to avoid just giving money to their heirs. Often these loans are generated to help the heir purchase a home or business. 30-year mortgage rates are currently around 6% whereas intra family loans are based on the favorable Applicable Federal Rate (AFR).

The AFR is the lowest interest rate one could charge and avoid being treated as a gift for tax purposes. The current rates range from 2.37% to 3.22% depending on the term of the loan. These rates change each month, though the rate is locked in for the term when the loan is executed. One popular strategy is for children to purchase a home and borrow 80% using a traditional mortgage and the remaining 20% is lent by the parents. There are no origination or transaction fees associated with the family loan.

Another great purpose for an intrafamily loan is to transfer wealth and help avoid paying gift tax or 'dipping' into the lifetime exclusion. A parent or family trust may write a loan to a member of the next generation, who can invest the money or purchase a growing family business. Any investment return above the AFR is a tax-free gift. Coupling the loan with an Intentionally Defective Grantor Trust (IDGT) accelerates the compounding of asset growth outside of the estate.

The IRS does not review intra family loans as part of its annual process, however if you are ever subject to an audit it is important to have the proper documentation. At a minimum the promissory note should include an interest rate, a schedule showing dates and amounts of principal and interest payments and collateral (if any). Companies such as National Family Mortgage help families set up private mortgages and track payments. Or you may also use the family's attorney to write a draft and ask your wealth manager to keep track of the interest payments.

As with any loan there are income tax consequences for both the borrower and lender. Any interest received by the lender is considered interest income and is taxable at ordinary income tax rates. There are exceptions for loans under $10k, and a second for loans under $100k that are tax advantageous for the lender. If the borrower uses the funds to start a business, make investments, or buy a home the interest payments may be deductible. Borrowers cannot deduct interest payments if the loan is used to pay off credit card debt, personal expenses, or an unsecured home loan. The rules on deductibility for borrowers are complicated and it's where we collaborate with the tax advisor. Please reach out to your Wealth Manager with any questions.