



The Advantage of Family Loans

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When I started writing about intra-family loans back in 2009, these types of transactions were hardly mentioned in the press. While there's now a lot more coverage, some of it is confusing and even incorrect. So I thought this would be a good time for an update, especially since we may be on the tail end of very low interest rates.

Let's start with the main reasons for doing intra-family loans. We assume your borrowers can make the payments and have a good plan for the money:

- 1. The borrowers avoid lending fees**, which can be 2% or more of the loan amount.
- 2. The borrowers get a really good interest rate** (see box on next page), especially helpful if they have a weak credit history.
- 3. The loan is essentially a gift-tax-free transfer of wealth**, if what the borrowers earn on the borrowed money is higher than the interest rate charged.
- 4. Within the family, the loan can help build trust and develop responsibility**, accountability and entrepreneurial thinking.

Think Before You Lend

Can you afford to lose the loan money? Risk is the probability of a loss plus the consequences for you. If you're lending your children a chunk of savings you might eventually need, even a 20% chance they won't repay the loan means you probably shouldn't do it.

If instead:

- 1.** This is money you can afford to lose and can access fairly easily (without racking up a high tax bill);
- 2.** You're satisfied with a lower return on this money;
- 3.** You intend to pass this money on to your heirs anyway; and
- 4.** Your borrowers have a reasonable plan for the money and can pay the interest due.

If all these things are true, then a family loan at today's rates could make a lot of sense.

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How Much to Charge

The answer is: the Applicable Federal Rate (AFR), shown in the box for loans made during April 2015. As you can see, the applicable rates are very attractive, even if your borrowers could get the lowest possible market rate from a traditional lender because of their stellar credit. Add in the fact the borrowers won't have lending and origination fees to pay, and the savings are even greater. Be aware that these rates change every month. So you need to use the rate specific to the month you "close" the loan.

Of course, you can charge less than the federal rates at the time of the loan. But if you do, a portion of your loan will be treated (and taxed) as a gift.

Really Low: Applicable Federal Rates (AFR) (April 2015)

Loan Term	Minimum Interest Rate (per year, fixed)
0 to 9 years	0.48%
Over 3 to 9 years	1.70%
More than 9 years	2.47%

SOURCE OF DATA: Rev. Rule 2015-4, IRB 2015-10.

Family Arbitrage

What will be done with the loan? The best use of the money is an investment that's likely to generate a higher return than the interest rate charged – say to buy or renovate a house or invest in securities. At current rates for a three-to-nine-year term, anything that earns an average annual return of more than 1.7% would be a transfer of wealth to the next generation.

The actual return will likely take years to materialize, and the interest payments should normally be made each month. But there's a lot that can be done to make the loan suit the borrower's needs, while staying within the rules. For example, you can lend the entire amount for a house purchase, avoiding the need for a down payment, or the loan can be set up as interest-only.

For Example: Myra lends \$400,000 to her son Willy, to buy a \$480,000 fixer in an up-and-coming neighborhood. Term is 30 years, at 2.47%, so Willy's monthly payment to his mom is \$1,570.10 a month. Had he borrowed from a bank, his monthly payment would be \$316 higher (3.9% rate). It gets better, though. Myra doesn't need the money, so she specifies interest-only repayments – just \$830 per month. With the money saved on the mortgage loan – about \$1,056 a month – plus his own savings, Willy fixes up the house and sells it in six years for \$600,000.

The Results: Willy has \$120,000 in profits. Myra gets her \$400,000 back plus a 2.47% pre-tax annual return, considerably more than what bank CDs or money markets are now paying.

Playing by the Rules

Money transfers between family members are considered gifts, unless you have a documented creditor-debtor relationship. What does this mean? You need a signed written agreement with a fixed schedule for repayment. To secure the lowest rates for the entire loan term, there must be a fixed repayment date. Other things to keep in mind:

- The borrower should have the financial ability to actually make the loan payments.
- If the loan is used to buy a house, the borrower can claim a tax deduction for mortgage loan interest (subject to IRS rules), but only if the loan is secured by the house. If the borrower uses the money for other investments, the interest paid may qualify for the tax deduction on investment interest, again subject to IRS rules.
- Both parties should keep accurate records of all principal and interest payments in case the transaction is questioned by the IRS.
- The lender can opt to forgive up to \$14,000 annually in interest payments (maxing out his/her annual gift tax exclusion). However, although not actually received, the annual interest due will still be considered taxable income for the lender.

Making It Real

To prove an intra-family loan is a real loan and not a gift, a basic amount of paperwork is a must. For a fee, there are now companies that handle all the processing and documentation for intra-family loans, including recording a mortgage loan with the county, processing insurance and taxes, and keeping track of payments. Please contact your LNWM advisor if you're interested in finding more about how family loans work and referrals to document processors.

Consider Your Estate

Finally, don't forget the estate planning consequences of a loan. If you have three children, for example, and have made a large loan to one of them, you probably need to adjust what's inherited by whom to reflect the loan. You probably don't want your kids to owe money to each other.

What happens in case of death? If the lender dies, his/her estate will own the loan and continue to receive payments until the estate settles. The borrower may actually inherit his or her own loan, in which case it would never need to be repaid. If the borrower dies, his/her estate has to repay the loan; if not, it's considered a gift.

We're here to help. For more information on intra-family loans, and if/ how this might make sense given your situation, please contact your LNWM advisor. ■



ABOUT THE AUTHOR

KRISTI MATHISEN serves as Laird Norton Wealth Management's in-house expert on tax and estate planning issues. She provides advice on philanthropic strategies to the firm's client service team and to clients directly.

She is an attorney and CPA and has more than 20 years of finance-related experience, much of it in accounting. Kristi has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. She is a member of the Washington State and King County Bar Associations, the Washington State Society CPA and the American Institute of CPAs.

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