The Advantages of Family Loans

By Kristi Mathisen, JD, CPA, PFS

KRISTI MATHISEN

LNWM's in-house expert on tax and estate planning, Kristi is an attorney and CPA with more than 20 years of experience in financial services.

When I started writing about intra-family loans 10 years ago, this type of private lending was hardly mentioned in the press. There's certainly a lot more coverage now, but some of the information provided is confusing and even incorrect. So I thought this would be a good time for an update, especially since longer-term lending rates have dropped recently.

Let's start with the main reasons for providing loans to family members, assuming that based on what you know 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 money you loan? 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 want or need for something else, 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.

Laird Norton Wealth Management

801 Second Avenue
Suite 1600
Seattle, WA 98104

www.lairdnortonwm.com
206.464.5100 | 800.426.5105

How Much to Charge

The answer is: the Applicable Federal Rate (AFR), shown in the box for loans made during August 2019. As you can see, the longer-term applicable rates are 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, however, that these rates change every month. So you need to use the rate specific to the month you "close" the loan.

Of course, you could charge more or less than the AFR rate. However, if you charge less than the noted federal rates at the time of the loan, a portion of your loan will be treated (and taxed) as a gift.

Relatively Low: Applicable Federal Rates (AFR)
(August 2019)

Loan Term	Minimum Interest Rate (per year, fixed)
0 to 3 years	1.91%
Over 3 to 9 years	1.87%
More than 9 years	2.33%

Source of Data: Rev. Rule 2019-17, IRB 2019-32.

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 1.87% would be a transfer of wealth to the next generation.

Your borrower's investment return will likely take years to materialize, and the interest payments should actually be made to you per the terms of your loan agreement. But there's a lot you can do to make the loan suit your 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 2.5% per year, so Willy's monthly payment to his mom is $1,580.48 a month. Had he borrowed from a bank, his monthly payment would be $327 higher (3.99% rate). It gets better, though. Myra doesn't need the money, so she specifies interest-only payments – just $833 per month due from Willy. With the money saved on the mortgage loan — about $1,074 a month — plus his own savings, Willy fixes up the house and sells it in five years later for $600,000.

The Result: Willy has $120,000 in profits. Myra gets her $400,000 back plus a 2.50% pre-tax annual return, which is a bit higher than current money market rates.

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 the mortgage loan interest (subject to IRS rules), but only if the loan is secured by the house. If the borrower uses the money for othe rinvestments, 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.
- You, the lender, can opt to forgive up to $15,000 annually (maxing out your annual gift tax exclusion). Keep in mind that if you forego any of the monthly payments, you will still be taxed on the interest due to you, and forgiving interest will make your loan look more like a gift. Generally, family lenders who want to make a gift forgive the loan principal, not the monthly interest payments.

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 should change your will or trust and adjust what's inherited by whom to reflect any loans that are outstanding at your death. 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 can actually inherit his or her own loan, in which case it would never need to be repaid. If the borrower dies, his/her estate must repay the loan; if not, it's considered a gift from the lender.

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. She also provides advice on philanthropic strategies to the firm's client services team and to clients directly. An attorney, CPA and Personal Financial Specialist with more than 20 years of finance-related experience, Kristi has a bachelor's degree in business administration 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.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

DISCLOSURE

All investments involve a level of risk, and past performance is not a guarantee of future investment results. The value of investments and the income derived from them can go down as well as up. Future returns are not guaranteed and a loss of principal may occur. All investment performance can be affected by general economic conditions and the extent and timing of investor participation in both the equity and fixed income markets. Fees charged by LNWM will reduce the net performance of the investment portfolio.

The information presented herein does not constitute and should not be construed as legal advice or as an offer to buy or sell any investment product or service. Any opinions or investment planning solutions herein described may not be suitable for all investors nor apply to all situations. All opinions expressed are those of Laird Norton Wealth Management and are current only as of the date appearing on this material.

Any accounting, business or tax advice contained in this presentation (or communication, including attachments and enclosures) is not intended as a thorough, in-depth analysis of specific issues, nor a substitute for a formal opinion, nor is it sufficient to avoid tax-related penalties.

Some investments may not be publicly traded and they may only allow redemptions at certain times conditioned on various notice provisions and other factors as more fully described in the related offering and subscription documents provided at the time of the investment. Due to the nature of these types of investment funds, hedge funds, fund of funds, and similar partnership-like investment vehicles, they should be considered illiquid. In addition to restrictions on redemption, they often include holdback provisions that may delay a full redemption for several months or longer. There is no guarantee that the amount of the initial investment can be received upon redemption. Due to the nature of the tax reporting that may be available from these types of investments, clients should expect to extend the filing of their tax returns.

A benchmark is an unmanaged index, and its performance does not include any advisory fees, transaction costs or other charges that may be incurred in connection with your investments. Indices are statistical composites and are shown for informational purposes only. It is not possible to invest directly in an index. Indices are unmanaged and are not subject to management fees. Any benchmark whose return is shown for comparison purposes may include different holdings, a different number of holdings, and a different degree of investment in individual securities, industries or economic sectors than the investments and/or investment accounts to which it is compared. Comparisons of individual account or portfolio performance to an index or benchmark composed of indices are unreliable as indicators of future performance of an actual account or portfolio. Actual performance presented represents past performance net of investment management fees unless otherwise noted. Other fees, such as custodial fees or transaction related fees may not be reflected in the actual performance results shown.

Certain information herein has been obtained from public third party data sources, outside funds and investment managers. Although we believe this information to be reliable, no representation or warranty, expressed or implied, is made, and no liability is accepted by Laird Norton Wealth Management or any of its officers, agents or affiliates as to the accuracy, completeness or correctness of the information herein contained. In addition, due to the nature of an investment or the date of the creation of the attached presentation, some values shown or used in the calculation of performance may be based on estimates that are subject to change.

The attached materials may contain confidential information that is intended only for the person to whom it is presented. By accepting this information, you agree to maintain its confidentiality and not to distribute it to any other person without the express permission of Laird Norton Wealth Management. All data presented is current only as of the date thereon shown. Laird Norton Wealth Management is comprised of two distinct entities that may offer similar services to clients. Laird Norton Trust Company is a State of Washington chartered trust company. Its wholly owned subsidiary, Laird Norton Tyee Asset Strategies, LLC, is an Investment Advisor registered with the Securities and Exchange Commission. Such registration does not imply any level of skill or expertise.