

Abstract: Intrafamily loans can provide family members with financial support and encourage children to learn financial responsibility, all without diminishing one's "nest egg." But there are risks to consider. This article explains how an intrafamily loan should work and what to watch out for.

An intrafamily loan is worth careful consideration

Lending money — rather than giving it — to loved ones is an idea worth considering. Perhaps you're not ready to part with your wealth. For example, maybe you're concerned about having enough money to fund your retirement or you feel that your children aren't ready to handle the responsibility.

Intrafamily loans allow you to provide family members with financial support while hanging on to your nest egg and encouraging your children to be financially responsible.

How does it work?

The key to transferring wealth is the borrower's ability to take advantage of investment opportunities that offer relatively high returns. In other words, after paying back the principal, the borrower essentially receives the "spread" between the investment returns and the loan interest — free of gift and estate taxes.

With this in mind, when you lend money to family members, it's important to charge interest at the applicable federal rate (AFR) or higher. Otherwise you'll trigger unintended income and gift tax consequences.

AFRs are published monthly and vary depending on whether the loan is:

- Short-term (three years or less),
- Mid-term (more than three years but not more than nine years) or
- Long-term (more than nine years).

They also vary depending on how frequently interest is compounded.

Keep in mind that the loan balance is still included in your taxable estate. Even if you die before the loan is paid off, the borrower must repay the loan to your estate, though an intrafamily loan can be structured to provide that the loan will be forgiven if you die before it's paid off.

What are the risks?

The biggest risk is that the invested funds will fail to outperform the AFR. If that happens, your child or other borrower will have to use his or her own funds to pay some or all of the interest — and, if he or she experiences a loss on the investment, even some of the principal. In other words, instead of transferring wealth to your child, your child will transfer wealth to you. As noted above, however, low AFRs minimize this risk.

There's also a risk that the IRS will challenge the loan as a disguised gift, potentially triggering gift tax liability or using up some of your lifetime exemption. To avoid this result, you must treat the transaction as a legitimate loan. That means documenting the loan with a promissory note and adhering to its payment and enforcement terms. If, for example, your child is unable to make a payment, you should make a genuine effort to collect the funds from the child.

Who can help?

The intrafamily loan is just one of many tools available for transferring wealth to your loved ones in a tax-efficient manner. Contact our firm for help developing a strategy that reflects your financial situation and goals.

Sidebar: No-interest loans are a big no-no

When making an intrafamily loan, you must avoid the temptation to charge no interest or charge interest below the current applicable federal rate (AFR). If you do, you'll be subject to income tax (with certain exceptions for smaller loans) on imputed interest — that is, the excess of the AFR over the interest you collect. In other words, you'll be taxed on interest that you didn't receive. In addition, the imputed interest will be treated as a taxable gift to the borrower.

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