

Abstract: Because of the COVID-19 pandemic, many people have family members who are struggling financially. For those with wealth to share, making an intrafamily loan or establishing a family bank could be a way to help. This article explains the importance of carefully structured intrafamily loans and why a family bank might be a logical step.

Intrafamily loans and a family bank

Among the primary goals of estate planning is to put in writing how you want your wealth distributed to loved ones after your death. But what if you want to use that wealth to help a family member in need while you're still alive? This has become an increasingly common and pressing issue this year because of the COVID-19 pandemic and changes to the U.S. economy.

One way to help family members hit hard by job loss or increased debt is through an intrafamily loan or even by establishing a full-fledged family bank.

Structure loans carefully

Lending can be a way to provide your family financial assistance without triggering unwanted gift taxes. As long as a loan is structured in a manner similar to an arm's-length loan between unrelated parties, it won't be treated as a taxable gift.

This means, among other steps, documenting the loan with a promissory note and charging interest at or above the applicable federal rate (which is now historically low). You'll also need to establish a fixed repayment schedule and ensure that the borrower has a reasonable prospect of repaying the loan.

Even if taxes aren't a concern, intrafamily loans offer important benefits. For example, they allow you to help your family financially without depleting your wealth or creating a sense of entitlement. Done right, these loans can promote accountability and help cultivate the younger generation's entrepreneurial capabilities by providing financing to start a business.

Maybe open a bank

Too often, however, people lend money to family members with little planning or regard for potential unintended consequences. Rash lending decisions may lead to misunderstandings, hurt feelings, conflicts among family members and false expectations. That's where a family bank comes into play.

A family bank is a family-owned and funded entity — such as a dynasty trust, a family limited partnership or a combination of the two — designed for the sole purpose of making intrafamily loans. Often, family banks can offer financing to family members who might have difficulty obtaining a loan from a bank or other traditional funding sources, or lend at more favorable terms.

By “professionalizing” family lending activities, a family bank can preserve the tax-saving power of intrafamily loans while minimizing negative consequences. The key to avoiding family conflicts and resentment is to build a strong governance structure that promotes communication, decision making and transparency.

Establishing guidelines regarding the types of loans the family bank is authorized to make — and allowing all family members to participate in the decision-making process — ensures that family members are treated fairly and avoids false expectations.

Learn more

More than likely, someone in your extended family has faced difficult financial circumstances this year. Contact us to learn more about intrafamily loans and family banks.

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