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Intra-Family Loans: A Financial Resource to Consider in a Difficult Economy

Summary

- Intra-family loans can be a convenient, low-cost way to assist family members with purchasing a home, starting a business or paying living costs during the pandemic.
- Loans exceeding the $15,000 annual gift-tax exemption ($30,000 for couples) should be documented with a formal loan agreement specifying repayment terms to avoid being characterized as a gift.
- Family lenders should consider the potential impact on family relations if loans are perceived as unfair. They must be prepared to consider the loan a gift — with potential tax consequences — if the borrower is unable to pay interest or return principal in the future.

Introduction: What are intra-family loans?

Economic disruption during the COVID-19 pandemic may create a need for wealthy families to provide financial assistance to affected family members. After losing a job, a daughter or grandson may need help covering living costs, student-loan debt or getting a professional degree. Others may need help buying a home or starting a business.

Loans between family members — known as intra-family loans — are worth considering because current interest rates are very low and loans conforming to Internal Revenue Service (IRS) rules can avoid gift and inheritance tax consequences. Annual interest rates for loans made in July, for example, range from 0.18% for loans up to three years, 0.45% for loans three to nine years and 1.17% for loans greater than nine years — a fraction of commercial rates. What's more, rates are fixed for the loan term, so interest costs won't increase if rates rise.

Before making a decision, would-be lenders should consider the potential impact on family relations and perceptions of fairness. Solutions may include openly discussing the hardship creating the need for a loan, or making loans equally available to siblings or grandchildren.

What's involved in granting a loan?

Loans are easy to implement, although some paperwork is advisable for multiple reasons. Loans exceeding the $15,000 annual gift-tax exemption ($30,000 for couples) should have a formal loan agreement describing the terms, signed by both parties and notarized. Payments should be made on time, whether monthly, quarterly or annually, with interest income reported on the lender's income tax return. If the loan is a home mortgage, it's wise to record a lien giving family lenders a secured interest in the loan. This formality allows the borrower to claim mortgage interest when itemizing deductions, and gives the lender the right to foreclose on the property in case of default.

Advantages

Relatively lower interest costs, friendlier terms and fewer consequences if the family member can't repay the loan are among the potential advantages of intra-family loans, compared with commercial loans. For example, it would be difficult for a family member to get a 10-year, interest-only loan from a bank. There is also flexibility for lenders to forgive interest and principal up to the annual gift-tax exemption amount, without reducing their lifetime estate tax exemption. Family trusts that aren't providing current distributions can serve as a family bank, providing loans against each child's account, if permitted by the trust instrument.

Disadvantages

If the borrower stops interest payments or is unable to repay the loan, the IRS will consider the loan a gift. Amounts exceeding the annual exemption will trigger gift taxes or reduce the lender's lifetime $11.58 million estate and gift tax exemption ($23.16 million for couples). So, it's important for family borrowers to commit to meeting their loan responsibilities, sparing lenders the potential tax consequences. Similarly, lenders have to be prepared to consider the loan a gift, or foreclose on a defaulted mortgage. Borrowing from family also means not building up a credit history usually required to obtain credit cards or other commercial loans.

Intra-Family Loans

Potential Advantages	Potential Disadvantages
Lower interest costs	Failure to make interest payments or repay principal can trigger annual gift taxes and reduce lifetime estate tax exemption
Easier repayment terms	Granting loans to some family members and not others may cause family conflict
Loan can be treated as a gift if borrower is unable to pay interest or principal	Reduces assets (capital and income) available to lenders
Frequently used to finance home purchases or start a business	Lenders may have to pay taxes on appreciated assets sold to grant a loan
Ability to borrow against assets held in trust	Borrower does not build a commercial credit history

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Addressing potential family conflict over who gets a loan

The most challenging aspect of intra-family loans can be the potential for family conflict caused by perceptions of favoring some family members over others. A potential solution is openly discussing the need and potential benefits of providing a loan, and addressing concerns about unfairness. For example, parents could make equal loans available to each sibling. Lenders should acknowledge, however, the potential for a loan to reduce the size and growth rate of an estate, diminishing the inheritance of other family members.

Family trusts can be divided into separate accounts for each beneficiary, so that unpaid loan interest or principal would be charged against a borrower's future trust distributions.

To learn more about intra-family loans, contact your relationship manager or visit us at glenmede.com.