GLENMEDE
PRIVATE WEALTH

Intrafamily loans: A financial resource in a rising interest rate economy

Summary

- Intrafamily loans can be a convenient, low-cost way to assist family members with purchasing a home, starting a business or paying living costs, especially as interest rates rise.
- Loans exceeding the $16,000 annual gift-tax exemption for individuals ($32,000 for couples) should be documented with a formal loan agreement specifying repayment terms to avoid being characterized as gifts.
- Family lenders should consider the potential impact on family relations if loans are perceived as unfair. Lenders 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.

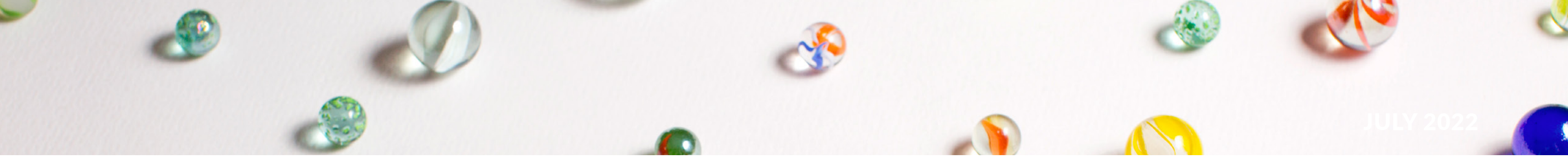
What are intrafamily loans?

Difficult economic times, rising interest rates or other circumstances may create a need for wealthy families to provide financial assistance to affected family members. After losing a job, a child or grandchild may need help covering living costs, repaying student loan debt or getting a professional degree. Others may need help buying a home or starting a business.

The IRS permits family members to borrow money from each other at a special rate, called the Applicable Federal Rate (AFR). An intrafamily loan must be structured so that it is not considered a gift — it must have a written promissory note, require repayment, charge interest (if the loan is more than $10,000) and provide remedies for default. Intrafamily loans may be worth considering while current interest rates are comparatively low and loans conforming to IRS rules can avoid gift and inheritance tax consequences.

The IRS sets the AFR each month, and the interest on the intrafamily loan must equal the AFR. The rate differs depending on the period for compounding of interest and on the term of the loan, which can be short (3 years or less), midterm (over 3, but not more than 9 years) or long (over 9 years). (You can find the latest month's AFR here.) The AFR is typically lower than bank interest rates, and the borrower's credit does not affect the loan. Rates are fixed for the loan term, so interest costs will not 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 is involved in granting a loan?

Loans are relatively easy to implement, although some paperwork is advisable for multiple reasons. Loans exceeding the $16,000 annual gift-tax exemption per person 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 is 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 more flexibility are among the potential advantages of intrafamily 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 choose to forgive interest and principal up to the annual gift-tax exemption amount without reducing their lifetime estate tax exemption, or to make a gift in the form of forgiveness of indebtedness, so long as it is not part of a prearranged explicit or implicit plan. Family trusts that are not 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 $12.06 million estate and gift-tax exemption ($24.12 million for couples). So it is 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 adhere to the specified default provisions, such as foreclosing 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.

To learn more about intrafamily loans, contact your Glenmede Relationship Manager or visit glenmede.com.

Potential Advantages	Potential Disadvantages
Lower interest costs; interest payments remain in the family	Failure to make interest payments or repay principal can trigger annual gift taxes and reporting requirements, as well as 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; lender may have imputed interest income
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

 PWEVG039-0622