

Intrafamily loans

An intergenerational wealth-building strategy for financially successful families



Wealth
Management

Intrafamily loans can be an attractive tool for parents and grandparents who wish to help their children or grandchildren make a desired purchase or invest for the future. Many high-net-worth families are taking advantage of the current low interest rate environment to make loans to their family members.

The family members may then use the funds as they would with any loan, such as a mortgage or an auto loan. Other times, the family members use the funds to invest in instruments that may provide a higher rate of return that could outperform the current rate of interest.

Applicable federal rates

To put an end to interest-free or below-market loans, in 1984 Congress enacted IRC section 7872 to address the treatment of loans with below-market interest rates. Since then, the IRS has been required to provide a set of floating interest rates on a monthly basis called applicable federal rates (AFRs). These rates provide the minimum rate of interest to be charged for both demand and term loans in order to avoid adverse income and gift tax consequences. The rate is based on the term of the loan as follows:

- **Short-term** — Three years or less
- **Mid-term** — More than three years and less than nine years
- **Long-term** — More than nine years

These rates are near historic lows and are typically lower than what is available on a commercial basis through financial services providers such as banks, credit agencies or savings and loans. The following provides two examples of how this may benefit your family.

Traditional loan arbitrage

Assume a hypothetical 30-year mortgage rate is 4%. For a \$500,000 home, the monthly payment would be \$2,387 and the total interest payments would be \$359,348 over the lifetime of the mortgage. Instead, if a parent loans their child \$500,000 at 1.62% interest (the long-term AFR for a term of more than nine years, as of March 2021), which is 2.38% less interest on the loan, the child's monthly payment is \$1,755. This would reduce their interest payments over the lifetime of the loan to \$131,634 for a total savings of \$227,714.

To further enhance this strategy, a portion of each loan payment could be forgiven by using the annual gift tax exclusion. For example, if both parents are alive, they could each use their \$15,000 annual gift tax exclusion (2021) to forgive a total of \$30,000 of the mortgage payment each year.

Investment arbitrage

A grandparent loans a grandchild \$1 million for five years at 0.62% interest. The mid-term AFR for a term of more than three years and less than nine years, as of March 2021, is 0.62%. The grandchild purchases a five-year-term fixed income investment paying 5% interest annually. Over the course of the five years, the grandchild earns \$250,000 in interest and pays the grandparent \$31,000 in interest, creating \$219,000 in wealth for the grandchild. The retained earnings of the grandchild is not considered a gift and therefore does not count toward the annual or lifetime gift maximum. At the end of the five years, when the fixed income investment matures, the grandchild repays the loan principal. The grandchild is free to use the \$219,000 as they wish, for example, to pay for college expenses, buy a home or start a business. This strategy achieves transfers of wealth and, depending on the use of the borrowed funds, capital appreciation.

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How to implement an intrafamily loan strategy

- Develop a written agreement between parent/grandparent and child/grandchild or trusts for the benefit of children/grandchildren indicating the loan amount, the payment date, the stated rate of interest and any collateral or security.
- Loan the money to a child/grandchild or trust.
- The child/grandchild or trust pays interest to the parent or grandparent.
- The child/grandchild or trust repays the principal to the parent or grandparent.
- The parent or grandparent could also make a separate and noncontingent annual exclusion gift to the child or grandchild (\$15,000 in 2021).

Income tax considerations

- If the intrafamily loan is at or above the applicable AFR interest rate when the loan documentation is drafted, there is no gift tax.
- Interest paid by the related borrower is deductible if the loan is spent for business or investment purposes (up to net income).
- Interest may also be deductible if the loan is secured by a “qualified residence.”
- Interest paid by the related borrower is not deductible if the loan is used to pay personal expenses or is used for an unsecured home loan (not secured by the home itself).
- Interest received by the lender is taxable at ordinary rates as interest income.

Estate and gift tax considerations

- Intrafamily loans do not reduce the parent or grandparent’s estate, since the principal of the loans remains part of the lender’s estate.
- Often, a parent or grandparent may forgive a portion of the loan or payments. In certain circumstances, this may qualify as a noncontingent annual exclusion gift to the child or grandchild. Current tax laws permit individuals to gift up to \$15,000 tax free to as many recipients as they wish and a lifetime gift tax exemption of \$11,700,000 (in 2021). Married couples may gift up to \$30,000 in 2021 per recipient annually.

Next steps

Because this strategy is most appropriate for families with excess cash or other liquid assets, parents and grandparents should not risk their own future financial security using this strategy to help children or grandchildren build wealth.

For help determining if this strategy is appropriate for your financial circumstances and long-term goals, contact your financial advisor.