Family Loans When Interest Rates Are High

IRS rules may kick in when you're helping a relative in a tight spot.

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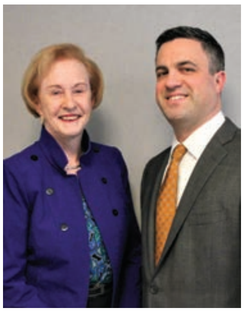

The Federal Reserve spent the first half of 2023 aggressively raising interest rates in order to combat the elevated inflation we saw in the wake of the pandemic. As a result, the interest rates on mortgage loans, auto loans and personal loans jumped significantly. By midyear, the average rate on a 30-year mortgage was up to 7.2%, while the average rate on a new car loan was 6.4%. Higher rates means higher payments, with the average monthly payment for a new car setting a record high of $736 in July.

Rapid inflation combined with higher interest rates has left many facing costs they're struggling to meet on their own. We have seen an increase over the past year in our clients helping family members, either through gifts or loans. While a gift is less complicated, in many cases an outright gift may not be appropriate. A loan may be preferable, but if you decide to go this route it's important to understand the mechanics and tax implications of a family loan.

CAN I HELP, AND IF SO, HOW?

The first decision you must make: Can I help? At the most basic level, you must be sure you can afford to provide help before offering assistance or the result will be two families in financial trouble, rather than one.

The second decision: Is this a loan or is this a gift? There are both financial and nonfinancial reasons to set up assistance as a loan or a gift. While we focus below on the financial mechanics of a family loan, open communication between all parties is critical to ensure that a financial transaction doesn't tear apart a family relationship.

As a lender, you must be clear in your intentions for giving the loan. This includes what you expect the money to be used for, how and when you expect to be repaid, what you will do if the borrower has trouble making payments, how the loan will affect other family members (such as siblings) and how it will affect your personal financial situation if payments aren't made.

As a borrower, it's important to clearly communicate your current financial situation, your plan for repayment of the loan and how you'll use the loan money.

Both sides need to be comfortable with each other's answers to these questions and that the loan will be a benefit to both parties.

COMMON FAMILY LOAN USES

There are a number of situations where an outright gift isn't feasible, but you may have the resources to help temporarily. A common motivation for a family loan is to provide a larger lump sum than the annual $17,000 gift exclusion per individual allows, without giving up control of the assets forever. This may be to assist with a down payment on a home, provide a bridge loan between the sale of one house and the purchase of the next, or help with significant education or medical expenses.

In addition, because of the rules related to family loans and interest rates, they can be used to lower the interest costs on existing debt that carries higher rates, such as credit-card balances or student loans.

Finally, a family loan can help ease some of the friction involved in obtaining a traditional loan. Family loans, when done properly, don't require a credit check, can provide a flexible payment schedule and can be made at low interest rates relative to commercial loans.

It's important to take care in how these loans are made and to understand the rules concerning both gifts and loans. The issues are similar no matter who is offering help to whom, but in the examples below we use the example of parents loaning money to children.

FAMILY LOAN MECHANICS

The mechanics of creating a family loan are critical. If not done properly, the Internal Revenue Service may assert that the entire amount is a gift and assess gift tax on the donor, so it's crucial that the loans be implemented properly.

First, the loan should be documented. A formal agreement signed by all parties should be signed, detailing the amount borrowed, the interest rate, the payment schedule and recourse for the lender in the event of missed payments. There are a number of resources online with sample templates, though to be thorough we recommend you have the document reviewed by an attorney.

Repayment of the loan can be structured in several ways. A common approach is to set up a monthly repayment of principal and interest, similar to a mortgage payment. Depending on the need for the loan, you may also have the borrower make interest only payments, with a balloon payment at the end of the term.

The interest only/balloon payment approach would work well in a bridge loan situation, where a child needs to make a down payment on a new home while their existing home is on the market. In this case, the child would make (low) interest-only payments on the family loan and then pay off the family loan when the existing home sold.

FAMILY LOANS CAN CARRY LOWER RATES THAN TRADITIONAL LOANS

With a traditional loan, the party making the loan will charge as much interest as reasonably possible and will recognize that interest as income. Family loans are a special subset in the loan world and have their own set of rules surrounding interest, and we need to be aware of several topics in particular. First is the "AFR," or applicable federal rate.

The AFR is the minimum interest rate set by the IRS that a lender can charge for a legitimate loan. An interest rate below this threshold is considered a gift. The AFR is declared monthly by the IRS and is based on the repayment period of the loan. For August 2023, assuming monthly payments, the AFRs are 4.96% for a short-term loan (three years or less), 4.02% for a mid-term loan (three to nine years), and 3.96 % for a long-term loan (nine or more years).

Thus, a family loan could be helpful reducing interest costs on outstanding credit card debt, which often carries an interest rate of 20% or more. A parent could make a loan to pay off that debt and replace it with a family loan carrying an interest rate of 4.02%.

CAN I MAKE AN INTEREST-FREE LOAN?

If a no-interest loan is made from parent to child, the IRS assumes that the child paid the AFR interest to the parent ("imputed interest"), and the parent may be required to pay income taxes on that amount, even if they didn't receive it.

However, there are two situations where you can make an interest-free loan and avoid tax on the phantom interest. These are the $10,000 rule and the $100,000 rule.

The $10,000 rule states that the below-market imputed interest rules don't apply to loans with a total amount of less than $10,000 on any given day. This exception does not apply if the loan proceeds are used to purchase income-producing assets.

The more limited $100,000 rule states that the below-market imputed interest rules don't apply where the loan is less than $100,000, if the child's net investment income is less than $1,000.

This means that if the parent wants to make an interest-free loan under the $100,000 rule, they must review the child's tax return each year to be certain their investment income doesn't rise above $1,000. If it does, the parent may be subject to tax.

In order to make an interest-free loan, the loan should be a "demand note." The borrower should have the right to demand repayment at any time. While this seems draconian, it's a requirement to qualify for the two no-interest loan exemptions detailed above. If not designated as a demand loan, the IRS will total all the interest for the life of the loan and count it as a gift in the year the loan is made, resulting in a large gift and potential gift tax burden.

FORGIVEN PAYMENTS

It's not uncommon for the parent to forgive loan payments, either for a given year or for the remainder of the loan. The IRS will consider any forgiven loan payments a gift by the parent to the borrower, and will count that amount toward your annual gift tax exclusion ($17,000 in 2023), or if you have already exceeded your annual gift tax exclusion to the borrower, toward your lifetime gift tax exemption, which is $12.06 million for 2023.

CONCLUSION

With the right planning and clear communication between all parties, family loans can be a win-win mechanism for helping to ease the financial burden of family and friends, while retaining long-term control of your assets and maintaining good family relationships.

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