NATIONAL WEALTH ADVISORS Inc.
Business & Personal Financial Planning

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SUMMIT FINANCIAL RESOURCES, INC.

Planning Alert: The Dos and Don'ts of Intra-Family Loans

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Planning Alert

How to Structure a Family Loan

In today's low interest rate environment, a properly structured loan from a wealthy parent to a child is a simple yet overlooked wealth transfer strategy. The return earned on the borrowed funds in excess of the loan interest is retained by the child and permanently removed from the parent's estate. In addition, such loans can provide the child with financing to start a business or purchase a residence, without treating the parents as if they made a gift. While the "Bank of Mom and Dad" can be a more attractive financing option than a traditional lender, the key to a successful structure is in the details. The loan should be designed and implemented with the advice of counsel familiar with federal tax law as well as state law requirements.

Do. Memorialize the loan with a Promissory Note outlining the terms and conditions, payment schedules, applicable interest rate, default events, etc. The Note should be signed by the child as borrower and otherwise executed in accordance with state law requirements. Charge sufficient interest to avoid imputed interest[1]. For example, a nine-year term loan entered into in July 2017 must charge interest of at least 1.89%, which can remain fixed until the loan is repaid. Create and calendar a payment schedule requiring the child to make timely payments. If a due date is missed, demand payment in writing. While an "interest-only with a balloon payment" arrangement may work, accruing the interest until the loan becomes due may not withstand I.R.S. scrutiny. Finally, consider what security or collateral the child can provide. If the loan is used to purchase a residence, the loan must be secured by the residence for the interest to be tax deductible as mortgage interest.

Don't. Since the I.R.S. presumes such loans are intended as gifts, don't ignore the requirements that a traditional lender may impose. For example, don't lend money to a child at a time when he or she has no ability to repay the loan or is insolvent. The borrower's financial condition is one of the factors courts will examine to determine whether a loan is a disguised gift. If your child misses a payment, don't give them a free pass. Instead, the Note should impose a penalty or additional interest charges just as a bank would. Also, don't forgive the loan prior to repayment since that reinforces the appearance of a gift. Finally, don't forget to report and pay tax on the loan interest each year.

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[1] While certain exceptions apply to limit imputed interest, this analysis assumes a loan in excess of $100,000.