When Helping Out a Relative, Be Careful of Tax Law Implications

The Best Approach to Family Loans

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In these interesting economic times, it's increasingly common to face the prospect of financially assisting family and friends. In particular, rapid increases in the price of housing, college tuition and medical care have left many facing costs they're struggling to meet on their own. Last month, we explored the tax implications of making gifts to friends and family. In many cases, however, an outright gift may not be appropriate. A loan may be preferable.

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 else 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. Although 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'll 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 money received from the loan. 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 $15,000 gift exclusion per individual that tax law 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 to 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's offering help to whom, but in the examples below we use the situation of parents loaning money to children.

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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 a gift tax on the donor, so it's crucial that the loan be implemented properly.

First, the loan should be documented. A formal agreement signed by all parties should be completed, 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 a local 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 particularly well in a bridge loan situation, where a child needs to make a down payment on a new home while an existing home is on the market. In this case, the child would make (low) interest-only payments on the family loan, then pay off the family loan when the existing home sold.

Traditional Loans Versus Family Loans

With a traditional loan, the party making the loan will charge as much interest as reasonably possible and it'll 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 January 2019, assuming monthly payments, the AFRs are 2.72 percent for a short-term loan (three years or less), 2.89 percent for a mid-term loan (three to nine years), and 3.15 percent for a long-term loan (nine or more years).

Thus, a family loan could be useful in reducing interest costs on outstanding credit card debt, which often carries an interest rate of 20 percent 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 2.72 percent.

Can I Make an Interest-Free Loan?

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

But 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. However, this exception doesn't 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 when the loan is less than $100,000, if the child's net investment income is less than $1,000. This means if the parents want to make an interest-free loan under the $100,000 rule, they must have the child's tax return each year to be certain the child's investment income doesn't rise above $1,000. If it does, the parents may be subject to tax.

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. Although this seems draconian, it's actually a requirement to qualify for the two no-interest loan exemptions detailed above. If the transaction isn't 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 isn't 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 the parent's annual gift tax exclusion, or if the parent has already exceeded the annual gift tax exclusion to the borrower, toward the parent's lifetime gift tax exemption. For more on the annual and lifetime exclusions, see our article in the January/February issue.

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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