Supporting Family with Private Loans

By Carla C. Wigen

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These are uncertain and trying times, but remarkable planning opportunities exist. If a family member or someone else you know and trust could use substantial financial support – either to make ends meet, or to take advantage of an opportunity – one option is to lend them money through a private loan. The interest rates on private loans are based on Applicable Federal Rates (AFR). As you can see below, these rates are now dramatically lower than those on consumer loans and mortgages.

Applicable Federal Rates (AFR) September 2020

Term of Personal Loan	Applicable Interest Rate (per year, fixed)
0 to 3 years	0.14%
Over 3 to 9 years	0.35%
More than 9 years	1.00%

Source: Rev. Rul. 2020-16.

Private loans require documentation to make them official and avoid being treated as gifts in the eyes of the IRS. But the extra paperwork could be worth it for these reasons:

- Your borrowers will avoid lender fees, which can be 2% or more of the loan amount.
- Your borrowers will get a really good interest rate, especially helpful if they have little credit history or a lower credit score.
- You can set flexible terms – for instance, you can specify that loan repayment is interest-only with a lump sum due in a certain number of years.
- A loan allows you to transfer wealth – including part or all of a business — to your heirs without gift taxes.
- A loan properly done can build trust and foster responsibility, accountability and even entrepreneurial thinking.

What to Consider

The key question: Can you afford to lose the money you loan? As we often say here at LNWM, risk is the probability of a loss plus the consequences for you. If you are lending to your children a portion of savings you might eventually want or need for something else, even a 20% chance they won't repay the loan means you probably shouldn't do it. We can help you evaluate what loan amount is manageable in the context of your long-term financial plan.

There are other important considerations:

- Can you access the loan amount fairly easily, without racking up a high tax bill?
- Are you satisfied with little or no return on this money?
- Had you intended to pass this money on to your heirs anyway?
- Do your borrowers have a reasonable plan for the money and can they at least pay the interest due?
- Are you confident that the loan will not jeopardize your relationship with the borrower?

If the answer to all the above questions is YES, then a private loan at today's rates could make a lot of sense.

Two Examples

As mentioned earlier, private loans can be used to support family members and also transfer assets to them. Below are examples of each:

Support: Marilyn lends $100,000 to her hard-working son Willy to start an online education business after he gets laid off from his first job out of college. The term is five years and it is an interest only loan. Willy's monthly payments to his mom would be roughly $29.17 (based on Sept. 2020 allowable rates), which he funds through part-time work as an online content moderator. Meanwhile, Willy uses the loan amount to pay rent, create his company website and market his services. After two years, Willy is seeing enough income coming in from his business that he can start to pay back the principal.

Transfer: Ben and Bertie Jones are close to retiring and want their children to buy them out of the family business, whose market value has dropped significantly during the COVID-19 pandemic. To facilitate that, they loan each of their two children $300,000 over nine years, interest only, resulting in annual payments of just $1,050 each per year. As the business recovers, the loan is repaid in five years, the Joneses have their $600,000 back (plus over $10,000 in interest) and the value of their business is out of their estate.

The above loan strategy can work well if the value of the business is expected to grow, if cash from the business can fund the loan payments, and Ben or Bertie outlive the duration of the loan. This is a simple example and there are other strategies using trusts that may be even more effective for larger amounts. It's worth noting that Washington State levies its own estate tax and the threshold for that is just under $2.2 million vs. the much higher $11.58 million for federal estate taxes (WA State has no gift tax). It's also important to note that unless renewed by Congress, the federal estate tax threshold could drop by 50% or more after 2025 (to between $5 million and $6 million), and the November 2020 elections may make that come even sooner.

Structuring Your Loan

The longer-term applicable rates are attractive now, even if your borrowers could get the lowest possible market rate from a traditional lender because of their stellar credit. Add in the fact the borrowers won't have lending and origination fees to pay, and the savings are even greater. Be aware, however, that these rates change every month with rates published around mid-month that apply to the next month. Of course, you could charge more or less than the AFR rate. However, if you charge less than the noted federal rates at the time of the loan, a portion of your loan will be treated (and taxed) as a gift.

Playing by the Rules

Money transfers between family members are considered gifts, unless you have a documented creditor-debtor relationship. What does this mean? You need a signed written agreement with a fixed schedule for repayment. To secure the lowest rates for the entire loan term, there must be a fixed repayment date. Other things to keep in mind:

- The borrower should have the financial ability to actually make the loan payments.
- If the loan is used to buy a house, the borrower can claim a tax deduction for the mortgage loan interest (subject to IRS rules), but only if the loan is secured by the house. If the borrower uses the money for other investments, the interest paid may qualify for the tax deduction on investment interest, again subject to IRS rules.
- Both parties should keep accurate records of all principal and interest payments in case the transaction is questioned by the IRS. For a fee, there are companies that handle all the processing and documentation for intra-family loans, including recording a mortgage loan with the county, processing insurance and taxes, and keeping track of payments. Please contact your LNWM advisor if you're interested in finding more about how family loans work and referrals to document processors.
- You, the lender, can forgive up to $15,000 annually of the loan amount (maxing out your annual gift tax exclusion). Keep in mind that if you forego any of the monthly payments, you will still be taxed on the interest due to you, and forgiving interest will make your loan look more like a gift. Generally, family lenders who want to make a gift forgive the loan principal, not the monthly interest payments.

Refinancing is an option. If you have already made a private loan, chances are the rate is much higher, since rates are down more than 50% in the past year. To help out your borrower, you could refinance the loan and reset the rate. Even if gift tax applies, the cash savings to your borrower could well outweigh the gift tax impact to you.

Consider Your Estate

Finally, don't forget the estate planning consequences of a loan. If you have three children, for example, and have made a substantial loan to one of them, you should consider changing your will or trust to adjust what goes to whom, given there might be an outstanding loan. You probably don't want your kids to owe money to each other.

If the lender passes away, his/her estate will own the loan and continue to receive payments until the estate settles. The borrower can actually inherit his or her own loan, in which case it would never need to be repaid. If the borrower passes away, his/her estate must repay the loan; if not, it's considered a gift from the lender.

We're here to help. For more information on family loans, and if/how this strategy might make sense given your situation, please contact your LNWM advisor.

About the Author

Carla C. Wigen is managing director of client services at Laird Norton Wealth Management. In this key role, Carla works to ensure that the full strength of LNWM's services is being applied strategically to achieve the goals of each client, and to develop new connections, resources and programs that help clients thrive in all aspects of their lives. To her work, Carla brings 25 years of experience as an industry leader in comprehensive wealth management, including investments, planning, trusts and estate strategies, and tax law. Carla earned a Juris Doctorate at the Seattle University School of Law and a Master's of Law at the University of WA School of Law. She has a Bachelor's in Business Administration from the University of WA and is a Certified Public Accountant.

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