

MAKING BELOW-MARKET-RATE LOANS TO YOUR CHILDREN

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This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

Many parents wish to lend money to their children at more favorable rates than those charged by banks and other lenders. If structured correctly, the below-market-rate loan can be a means, not only of helping the children achieve their financial goals, but also of shifting assets from the older to the younger generation with minimal income tax and transfer tax effects.

Loans Non-Gift Loans

To be recognized by the IRS as a loan and not treated as a gift, loans to children should include the same requirements as those imposed by institutional lenders on the general public. These requirements include an adequate interest rate, signed loan documents (detailing payback terms), and perhaps collateral. An adequate interest rate is defined as a rate that is not lower than the Applicable Federal Rate (AFR) for the month in which the loan is made. Three AFRs are set by the IRS each month and the correct rate to use depends on the term of the loan: the short-term rate is for loans lasting up to three years, the mid-term rate is for loans lasting more than three years but not more than nine years, and the long-term rate is for loans lasting more than nine years. For loans made during March 2010, for example, the short-, mid-, and long-term AFRs were 0.64%, 2.69%, and 4.35%, respectively. Thus, the rates the IRS considers adequate are significantly less than what a borrower would have to pay to a bank or other lender.

In low-interest-rate environments (such as currently), intra-family loans can be very attractive. The possibilities are numerous. A three-year loan at 0.64% to buy a new car certainly beats the current bank rate of about 3.95%. And the interest paid stays in the family rather than going to a bank or finance company. Or perhaps your son or daughter is purchasing a new home and the mortgage payments are a little rich for his/her budget. You could lend your child, say, \$500,000 to purchase a home with a 30-year repayment schedule, and charge an interest rate as low as 4.35%. Compared to current market rates of about 5.2%, the child's savings could be as much as \$250 per month.

These so-called AFR loans do carry some additional requirements. For one, the borrower must "pay" the interest but can do so via an increase to the loan principal. For another, the interest is generally taxable to the lender annually whether paid or added to the loan principal.

If interest rates go even lower than they are today, the parties can simply refinance the original loan. If rates go up, the child can still enjoy the benefit of the lower fixed rate for the remaining term of the loan.

If your goal is to transfer wealth to your child via the loan route, you could, for example, make a \$500,000 loan for nine years at the above-noted rate of 2.69%. As long as the child earns a rate greater than 32.69%, the child benefits from the arbitrage. If the child earns 7% and pays 2.69%, his pre-tax benefit would be \$21,550 annually.

Gift Loans

If parents wish to lend to their children at more favorable rates than the applicable AFR (e.g., a zero-interest loan), the IRS has rules requiring the lender to impute as income the difference between the actual rate and the AFR even though not received (phantom income) and to also treat the phantom interest as a gift to the child. This is what the IRS considers a “gift loan”. There are two exceptions to the “gift loan” rules and if a transaction fits within one of these exceptions, the lender (parent) does not report either phantom income from the child nor a taxable gift to the child even though the interest rate on the loan is below the AFR.

The first exception is for loans of \$10,000 or less (de minimis loans) as long as the funds are not used by the child to purchase or invest in income-producing assets. For example, if the child borrows \$10,000 at no interest, and uses it to pay off credit card debt, no income is imputed to the parent and the parent has not made a reportable gift to the child.

The second exception relates to loans up to \$100,000 from parent to child. If the child's net investment income (generally interest, dividends, and capital gains less investment expenses other than interest) for the year is \$1,000 or less, no interest is imputed to the parent and no gift is deemed made to the child. However, if the child's net investment income is more than \$1,000, then the interest is imputed to the parent, although it is limited to the amount of net investment income earned by the child. For example, Amy borrows \$100,000 at no interest from her parents to use as a down payment on a house. If Amy has investment income of \$1,000 or less, no forgone interest income will be imputed to the parents. However, if Amy has investments or savings accounts that generate \$1,500 of interest income, \$1,500 of income is imputed to the parents and they are considered to have made a gift to Amy of \$1,500. If the loan meets the requirements to be deductible mortgage interest (one of which is that the note is secured by the property), Amy could deduct the \$1,500 on her tax return as mortgage interest expense.

The Planning Opportunity

For parents whose intent is to provide substantial financial support to their children, the intra-family below-market-rate loan can be an excellent planning opportunity. We are available to discuss this with you, and help you structure the transaction appropriately for maximum advantage to you and your children.

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