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The Benefits of Intrafamily Loans

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As banks have tightened lending standards, a growing number of individuals are extending loans to relatives. But while such loans can yield significant financial benefits, families must carefully assess the risks.

With so-called intrafamily loans, borrowers can gain access to below-market interest rates and easier repayment terms than a bank might offer.

In recent months, the minimum interest rates the Internal Revenue Service requires on intrafamily loans have sunk close to all-time lows. Known as the Applicable Federal Rate, or AFR, the rate is currently just 0.2% for loans of three years or less, 1.27% for loans of more than three but less than nine years, and 2.8% for loans of a longer duration.

Lenders can realize benefits, too. Michael Joyce, a financial planner with offices in Richmond, Va., and Bethlehem, Pa., says two clients—a married couple in their early 60s—plan to lend $150,000 to their son and daughter-in-law to purchase a "starter home." In return, the parents will receive a 4% interest rate.

"The money was sitting in a bank account earning next to nothing," Mr. Joyce says. "They'll be able to get a much more competitive rate."

Families concerned about a potential estate-tax liability can also use intrafamily loans to transfer wealth tax-free to younger generations. For the strategy to succeed, the child must invest the money in something that earns enough to leave a profit after repaying the principal and interest. Still, says Andrew Feldman, a Chicago-based adviser, "it shouldn't be hard to find an investment that will do better than" the current short-term AFR of 0.2%.

To avoid any misunderstandings down the road, you should document the loan's amount, term, interest rate and repayment schedule in a formal written contract. Use an attorney or legal-services websites such as **legalzoom.com** .

In the event a lender dies with an intrafamily loan outstanding, a written contract will help the executor of the estate account for the debt outstanding—most likely by reducing the borrower's inheritance.

Financial planners say it's also important to assess the risk of a default. If a borrower has bad credit, advisers say, a lender should only lend what he or she can afford to lose.

"View it as a gift," advises Rick Kahler, a financial planner in Rapid City, S.D.

In some cases, it can make sense to request collateral. Mr. Joyce's clients will hold a first lien on their son's home.

It's also a good idea to set up automatic monthly payments from the borrower's bank account. Some lenders even hire an escrow service to keep track of payments and the balance due and prepare tax records.

The lender will have to pay tax on the interest income. The borrower can deduct interest payments on a mortgage and, generally, on a loan used to purchase investments, says Mr. Kahler.

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