

Both sides can win with loan from Mom and Dad

In most cases, I encourage parents to make sure that they fully fund their retirement savings before giving financial support to children for college, a home down payment or other reasons. But there are certain opportunities where using personal assets to run the Bank of Mom and Dad (BoMaD) can contribute to their financial security as well as help a child.

Intra-family loans are a little-used financial planning technique that can be attractive while interest rates are low. Once interest rates begin climbing, this option will be less attractive, so it may be wise to act now if the opportunity makes financial and family sense.

From a financial planning standpoint, there are many benefits to an intra-family loan:

- BoMaD, who is loaning the money, can likely obtain a better interest rate and higher income via the incoming loan payments than they would receive from CDs, money market funds or other cash savings.
- The loan recipient can receive better terms with a lower interest rate than is available from a commercial lender. In some cases, since lenders are more stingy than they used to be, this may be the only way to obtain a loan.
- Interest paid on the loan stays within the family.



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- In a scenario where estate and gift taxes are a concern, intra-family loans offer compelling wealth transfer options.

To avoid income or gift tax complications, an intra-family loan needs to follow IRS guidelines, but the loan itself can be fairly simple. Like any loan, make sure that it is properly documented with the terms (borrower, lender, length, interest rate) clearly established. This can be accomplished in a promissory note that creates a legal obligation.

The IRS provides loan guidelines for BoMaDs including an interest rate minimum set monthly. This is called the applicable federal rate (AFR). The rate depends on the length of the loan. For May, the AFR for monthly compounding of a short-term loan (36 months or less) is 0.56 percent. A loan from three to nine years has a minimum interest rate of 2.42 percent, and loans longer than nine years presently must charge at least 4.11 percent.

These interest rates are almost always lower than those available from a commercial lender. But the rates are only minimum guidelines; each BoMaD can set its own rate that may even out the benefits for both parties.

For example, assume that a child has student loan debt at 6 percent, or a car payment or credit card debt, and the BoMaD has an equivalent amount in cash that it would like to earn more interest than it currently does. The BoMaD can loan the money at a

rate that earns more interest than a CD or money market account – perhaps 4 percent over four years – and your child gets a large break on the interest component of his or her debt.

There are many other circumstances where dual benefits apply. In today's housing environment, many people are unable to refinance their homes because their house appraises for less than the balance of their loan. This usually gets into the territory of larger intra-family loans and may not work for many people but provides relief for some. If it is a mortgage loan, the BoMaD loan has to be secured by the home in order for the loan owner to deduct interest on his or her tax return.

Some might want to acquire an inexpensive loan from BoMaD to start a business or buy property. As long as the minimum AFR is applied to the loan and payments are actually made, no gift taxes apply. It's in scenarios like this where the wealth transfer goals of estate planning can be accomplished.

Certainly, mixing family dynamics and money decisions can create emotional circumstances. An intra-family loan should be done with careful planning to make sure the lender can actually afford it and that the probability of a mutually beneficial outcome is high.

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