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Have Your Kids Moved Home? Here Is a Better Alternative to Changing the Locks

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Your kitchen counter has become your child's home office, your oriental rugs are covered with Legos that you can't see, and a basketball hoop blocks your view of the TV.

If you have a child (and maybe his or her family) living at home after giving up a city apartment lease, perhaps you have begun to think about an alternative living arrangement. There is good news. With interest rates at historic lows, this is a great time to consider making a loan to your kids. They could use the funds to make a down payment on a first home. You can regain sole occupancy of your house.

Capitalizing on very low interest rates, some families are making intra-family loans for just that reason. The applicable interest rates (AFRs) that the IRS uses to compute the required interest rate on those loans are at a historic low. These rates, which are published monthly, are typically less than what would be charged by a commercial lender, thus making them very attractive.

The loan can be tailored to the needs of your child as long as the interest rate is equal to or exceeds the AFR and the loan is repaid. The August 2020 AFRs are 0.17 percent for a loan with up to a three-year term, 0.41 percent for a loan with up to a nine-year term, and 1.12 percent for a loan with a term of ten years or more.

The loan can be structured with an interest only payment schedule and balloon payment of principal at the end of the term. It can also be structured as a demand loan, and the AFR rate for determining interest will be at the lowest rate (currently 0.17 percent), recalculated twice a year using the short-term rate (if the short-term rate goes up, so does the interest rate on the loan). If the loan is secured by the home purchased by your child, interest payments on the loan may be deductible by your child, which will reduce his or her income tax. In addition, the mortgage provides protection against creditors of your child, including a spouse in a divorce.

<u>The Basics</u>

To capitalize on this opportunity, it is very important to carefully document the loan. A poorly documented loan might be considered a gift by the IRS. In addition, a written loan agreement that formalizes the transaction avoids serious legal disputes with other family members (especially siblings) down the road.

If the loan is an informal agreement and the interest rate is below the current AFR, or the loan does not have a repayment schedule, the IRS will penalize you twice:

- First, the interest that is not paid to you is nonetheless considered taxable income to you, and you will have to report this as interest income, based upon the AFR at the time the loan was made.
- Second, the IRS will assume you made a gift of the imputed interest income to your child. If the loan is more than $10,000, the IRS will apply the unpaid interest against your $15,000 annual gift tax exclusion.

By Way of Example

In March 2020, when the COVID-19 pandemic shut down New York City, Harry, son of Penny and Charles Jones, moved into his parents' Princeton home with his wife, Sarah, and their two-year-old son, Tom. In August, Harry and Sarah decide to give up their city apartment and permanently reside in Princeton.

Very anxious to regain sole occupancy of their home, Penny and Charles offer to lend $150,000 to Harry through a nine-year term loan, at an interest rate of 0.41 percent (the current AFR). Their written loan agreement requires Harry to make annual interest payments, with a balloon payment at the end of the term.

Penny and Charles will pay income tax on the $615 in interest payments they receive each year. Even if Harry does not make the interest payments, the IRS will treat the unpaid interest as phantom income, or imputed interest income, and Penny and Charles will have to report $615 as gross income. In addition, if the interest is never paid, Penny and Charles are assumed to be making a gift to Harry of $615 each year, which will count against their annual gift exclusion (currently $30,000 for a married couple who both file a gift tax return agreeing to split the gift). If Harry is in further need of cash down the road, Penny and Charles could make a separate non-contingent gift to Harry which he could use to pay the interest each year.

If the loan is secured by a second mortgage on the residence, interest may be deductible by Harry.

Note that unless Penny and Charles forgive the loan, any outstanding principal remains an asset of their estates.

If you are looking for a solution to an over-crowded house, an intra-family loan might be a great strategy. However, it can also backfire if you don't take extra steps to properly document the loan and carefully follow the IRS rules. If you would like to discuss whether an intra-family loan is appropriate for you and your family, please contact the author or a member of our practice.

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