



# HOW TO CREATE THE FAMILY BANK

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In this historically low-interest rate loan environment, intra-family loans have become a popular wealth transfer planning technique. The “Family Bank” concept has been around for many years, and of course is most popular in the proper interest rate environment. There are both advantages and disadvantages to the use of intra-family loans.

## Some advantages are as follows:

- **Arbitrage**  
If the asset the family member acquires with the loan proceeds has a combined income and appreciation in excess of the interest rate that is paid on the loan, this will result in a wealth transfer without gift tax implications.
- **In the Family**  
The interest payments remain in the family instead of being paid to a third party lender.
- **Poor Credit**  
Intra-family loans may be the only source of needed liquidity for family members with poor credit histories.
- **Closing Costs**  
Borrowing from outside lenders may entail significant costs and other expenses that can be avoided.

## Some disadvantages are as follows:

- **Treated as a Gift**  
The IRS may treat the transfer as a gift, even if a note is given in return for the transfer. There is a presumption by the IRS that the loan is a gift if the loan is not at “arms-length” or if there appears to be an intention that the loan will never be repaid. This can be overcome by a substantive showing of a bona fide loan with a real expectation of repayment and an intention to enforce the debt.
- **Administrative Considerations**  
There should be a signed promissory note, a fixed repayment schedule, use of an interest rate at or above the IRS prescribed “AFR” rate, use of demand terms in the promissory note, and use of collateral by the borrower. Make interest payments, maintain good records, and make sure the borrower is solvent.
- **Income Tax Consequences**  
Whether the interest is actually received or accrued, the lender must recognize interest income on the note receivable for tax purposes.
- **Note Receivable in Estate**  
If the lender dies before the note is extinguished, it will be reported as an asset in the lender’s estate. This is likely to raise additional scrutiny by IRS auditors looking into the facts surrounding the note receivable.
- **Intra-Family Loans**  
Can be a powerful wealth transfer technique in this current low interest rate environment. It is important, however, to follow the proper intentions and parameters listed above in order to ensure that the loan is a “bona fide” third party loan.