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Need a loan? You might consider borrowing money from the Bank of Mom and Dad

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I first wrote a related version of this article in May 2011 when the U.S. Federal Reserve was near the middle of what turned out to be a seven-year period with its interest-rate target just above zero percent.

At the time, I covered how families could use the Bank of Mom and Dad to better meet the interests of two generations during this extremely low interest-rate environment. Over the past year, the circumstances have shifted, with interest rates now at 15-year highs, but intra-family loans might be worth considering.

A decade ago, retirees were looking for ways to enhance their meager income from savings vehicles such as money market funds, certificates of deposit or Treasury bills. Conversely, children who might have needed loans for college, a home purchase or other debt-financed endeavors, would have been happy to pay their parents a higher rate of interest than they could receive from the bank but still receive a lower rate of interest on their loan than a commercial lender would charge. For instance, if the bank wanted to pay out less than 1 percent for a CD but wanted to charge 5 percent or more for a student loan, car loan or mortgage, then it would be advantageous for both parents and children to meet in the middle with a loan at say 3 percent interest. The parents would receive more income and the child would have less interest build up, reducing their total debt.

Now, with interest rates having increased at a faster pace than any time in the past 40 years, the situation has changed. Parents can earn more attractive income yields on their savings, but children seeking loans have seen the cost climb. The national average 30-year mortgage rate at the end of April was 6.92 percent. Federally sourced student loan debt ranges from 5 percent to 7.5 percent. Private student loans can be higher. Auto loans are available for less but are highly dependent on credit score, which can cause the interest rate to climb quickly for the less credit-worthy.

A parent might be happy to help a child avoid higher-cost debt in order to buy a house, pay down credit card debt or start a business. A child might be thrilled with an opportunity to reduce interest cost by even 1 or 2 percent, at least until they can possibly find less expensive financing in the future if interest rates retreat some, as they are expected to.

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

- The family member who is loaning the money, might obtain a better interest rate and higher income via the incoming loan payments than they would receive from other savings options.
- The loan recipient could receive better terms with a lower interest rate than is available from a commercial lender. In some cases, since lenders have recently become more tightfisted, this may be the only way to obtain a loan.
- Interest paid on the loan stays within the family, not on the bank's income statement.
- There are no closing costs or credit checks required as part of acquiring the loan.

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

The IRS provides guidelines for personal loans, 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 2023, the AFR for monthly compounding of a short-term loan (36 months or less) is 4.21 percent. A loan from three to nine years has a minimum interest rate of 3.51 percent, and loans longer than nine years presently must charge at least 3.66 percent.

Those interest rates are typically lower than those available from a commercial lender. But the rates are only minimum guidelines, each personal lender can set their own rate that might even out the benefits for both parties.

As long as the minimum AFR is applied to the loan and payments are actually made, the loan is not considered a gift and there is no need to track annual gifting on your tax return against your lifetime gifting exemption amount.

Certainly, mixing family dynamics and money decisions could create emotional circumstances. Considering an intra-family loan requires careful planning to make sure it is in the interest of the parent/lender and that the child/recipient would be in good position to make the payments to the Bank of Mom and Dad.

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