



OSBORNE PARTNERS
Capital Management, LLC

Intrafamily Loans

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Intrafamily loans can offer high-net-worth families a powerful arbitrage opportunity by reducing borrowing costs and minimizing future tax liabilities.

For many high-net-worth families, structuring an *intrafamily* loan can be a highly beneficial, yet often overlooked planning strategy. In this article, I present three distinct ways an intrafamily loan can be leveraged as an effective financial planning tool:

1. Lower borrowing costs for first-time home buyers (i.e. parent-to-child promissory note)
2. Freeze future appreciation & estate taxes (i.e. IDGT, Intentionally Defective Grantor Trust)
3. Seller-financed business sale at minority discount (FLP, Family Limited Partnership)

Additionally, I will explore the pros and cons of these three intrafamily loan strategies, logistics, tax considerations, and mistakes to avoid when structuring them.

Before delving into each of the three strategies, it is crucial to understand what makes intrafamily loans so universally appealing, regardless of their use (i.e. family lending, estate planning, or tax management). A large part of their value is due to the arbitrage in the interest rate differential between a conventional commercial lender and the federal government.

For example, for a conventional loan, a *commercial lender* needs to account for many risks during the underwriting process, including credit and prepayment risk. Additionally, they need to account for origination costs and earn a profit. Due to these risk premiums and profit motive, a commercial loan (i.e. mortgage) is priced at a spread above the 30-year Treasury bond. On the flip side, for *individual private transactions* (under the rubric of “intrafamily loans”), the IRS simply requires a minimum interest rate, or AFR (Applicable Federal Rate) to be set between lender and borrower; everything else is secondary. If the lender meets the “floor” of this AFR, the loan is not categorized as a taxable gift for the purposes of the federal government.

In short, the **lower rate (AFR) approved by the IRS allows intrafamily loans to be a much cheaper way (than bank lending) to effectuate many financial planning strategies**, including family lending, estate planning, and tax management.



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FAMILY LENDING – PROMISSORY NOTE

One use of an intrafamily loan is for parents to help their children lower the borrowing cost when buying a first home.

First, close your eyes and try to remember the experience of buying your first home. Perhaps, feelings of palpable excitement and fresh promise come to mind. Or, quite possibly, the feelings of emotional and financial stress also bubble up from the deep recesses of memory. Faced with the financial burden of buying their first home, it is likely that your adult children feel more pressure than promise in the current moment, and for good reason.

For one, mortgage rates are currently twice as high as they were just five years ago.¹ In addition, the lack of affordable housing, tighter credit and lending standards (post-2008 housing crisis), and a dearth of entry-level jobs add enormous challenges for young adults faced with the prospect of buying their first home. For these reasons, an intrafamily loan may make sense.

Hypothetical 1: Tom and Cindy Von Hetting are a young family living in the Bay Area looking to buy their first home. Let's assume they pass the strict credit and underwriting standards (high FICO, low debt-to-income ratio) and prequalify for the lowest mortgage rate on the market. After providing a 25% down payment, they secure a \$1,000,000 non-conforming jumbo loan. Based on today's rates (as of the writing of this article), their 30-year jumbo loan would be priced at ~6.25%. The monthly payments for this young family would set them back **\$6,157**.

Hypothetical 2: Tom's parents decide to lend him the \$1,000,000, so he doesn't have to secure an expensive bank mortgage. The family drafts a promissory note, and they characterize it as an "intrafamily loan." Further, the intrafamily loan is tied to the long-term AFR of 4.63%.² Assuming a 30-year amortization schedule, Tom would owe his folks **\$5,167** per month (principal and interest), or \$1,000 per month less than the bank jumbo loan under hypothetical 1!

Hypothetical 3: Tom's parents opt to lend him \$1,000,000, but they draft the intrafamily loan payments as "interest-only." To further lessen the burden for Tom's young family, they set the rate at the short-term AFR (vs. long-term). Other provisions - including the right to refinance and a balloon payment - options are added. Based on a 3.53% AFR, the new monthly payment would be **\$2,941** per month, or \$3,215 less than the original jumbo loan under hypothetical 1!

There are additional benefits beyond the lower monthly loan payments for the children, not to mention the parents, creating a mutual benefit. For example, the borrower would be able to deduct their loan interest payments against their income (on Schedule A, up to \$750,000), which is a tax benefit. While the lender would owe income tax on the interest paid to them, they would still receive ~3.5% on idle cash (akin to money market rates) and have the satisfaction of helping their children.



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ESTATE PLANNING – FREEZE FUTURE APPRECIATION AND ESTATE TAX

Intrafamily loans can also be an effective tool to implement estate planning strategies. By setting up an IDGT (intentionally defective grantor trust), a family can leverage an intrafamily loan to freeze the future appreciation of high-growth assets (i.e. stock, real estate, or business assets). Just like the previous example (parent-to-child promissory note), the utility of the IDGT as an effective estate planning strategy is due to the arbitraging of the interest rate differential – this time between the AFR and the high growth asset.

Hypothetical: Alexandra McFagan is an executive at a medical device company. Over her 25 years at the company, she has seen her company shares increase 20x in value. Even though the industry recently pulled back on tighter regulations, her \$10,000,000 in corporate stock has an adjusted cost basis of \$500,000 and significant unrealized capital gains. The recent drop in price, coupled with significant unrealized gains, and exciting new medical patents make Alexandra reluctant to sell. The shares also pay a juicy 3% dividend which has been consistent over the years.

Alexandra decides that an IDGT is a great vehicle to consider as part of her overall estate plan. When fully implemented, Alexandra will have swapped the high growth stock out of her taxable estate, in exchange for a low interest-bearing note.

Alexandra takes the following steps:

Step 1: She drafts an IDGT (with attorney) and initially gifts cash (seed money) into the trust.

Step 2: She (as grantor) sells the \$10,000,000 in company stock to the IDGT in exchange for a promissory note.

Step 3: She sets the interest rate of the promissory note at the long-term AFR (> 9 years), or 4.63%.

In essence, by swapping a high growth asset out of her estate for a promissory note, her estate is freezing the future appreciation of said growth stock. By default, not only is the future appreciation sheltered from the 40% estate tax, but the “swap” is not part of the lifetime gift exclusion.

Put more simply: If the company stock has a higher long-term return than the interest owed on the promissory note, this strategy provides estate tax arbitrage.

Fast forward 20 years from today. Let’s make the following assumptions: First, Alexandra’s company stock earns 10% per year (after-tax) inside the IDGT. Second, although the IDGT pays the grantor 4.63% per year (AFR of intrafamily loan), a large part of the cost is supported by the stock dividend. The differential between the growth rate of the company stock and AFR of the promissory note results in significant appreciation outside of the taxable estate.

The \$10,000,000 (from the initial swap) has grown to \$28,466,862 over 20 years – after interest payments and taxes (paid by the grantor)! More importantly, this sum has been irrevocably removed from the taxable estate. The rate of 40% not paid in estate taxes on the \$18,466,862 growth amounts to savings of \$7,386,745!

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One thing to note: an IDGT requires that the grantor pay the taxes, not the trust itself. This fact is very important to understand.

FAMILY BUSINESS SALE – FLP (FAMILY LIMITED PARTNERSHIP)

Last, intrafamily loans can also be used to finance the sale of a family business at a minority discount. For this strategy, an intrafamily loan (between parent and children) is often paired with an FLP (Family Limited Partnership).

There are four primary benefits. First, the AFR on the loan provides an incredibly low interest rate. Second, the FLP structure enables a minority discount and a reduced sales price (from parent to child). Third, the sale of the business shifts the future growth to the children. Lastly, any capital gains are spread over the life of the loan.

Hypothetical – Maria and Zac are owners of a family business that has been appraised at \$10,000,000. They want their five children to eventually own the business, however, they have other considerations. For example, they want to minimize their lifetime gifting exemption, maintain some control, and freeze estate value. Maria and Zac decide to form an FLP and combine it with an intrafamily loan.

For the first step, Zac and Maria create an FLP and include their business under the partnership. The initial ownership is 1% owned by their five children, and 99% owned by Maria and Zac.

For the second step, Zac and Maria gift 40% of their interest to their five children, or \$4,000,000. The good news is that they can discount this gift at a 32% rate, due to lack of control (i.e. voting) and marketability. In short, this \$4,000,000 gift uses up only \$2,720,000 of their lifetime exemption ($\$4,000,000 \times \{1-32\}$)! The five kids now own 40% of the family business at a steep discount.

For the third step, Zac and Maria sell the remaining 60%, or \$6,000,000 to their kids through a seller-financed intrafamily loan. Let's assume that the terms are over 15 years and at the low AFR rate of 4.5%. Again, due to the 32% discount (lack of control and marketability), the loan value is priced even lower, at \$4,080,000 (1-32%). The interest payments due (based on AFR) are \$377,000 per year.

To help ease the burden on their five children, Maria and Zac use their annual gifting exclusions to help with cash flow. As previously mentioned, these annual gifts don't eat into their lifetime gift since they don't bump over the annual exclusion. However, the annual gifts do reduce their taxable estate. As importantly: assuming Maria and Zac gift \$38,000 to each of their five children and their spouses, the annual gifts completely offset the loan payment ($\$38,000 \times 10 \text{ gifts} = \$380,000 \sim \text{annual loan payment}$).

In effect, the parents used an intrafamily loan coupled with an FLP to transfer their business to their kids. Not only did the minority discount lower their initial taxable gift and subsequent sale, but the transfer spreads out capital gains and freezes the future appreciation out of their taxable estate. The cherry on top?



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Their annual gifts (up to the exclusion) essentially offset the cost of the interest payments owed by their five children.

MISTAKES TO AVOID

When structuring intrafamily loans, there are four main mistakes to avoid.

The first mistake is applying an interest rate that is less than the AFR. If the IRS were to audit this occurrence, the loan automatically becomes a taxable gift subject to lifetime exemption. Intrafamily promissory notes (real estate purchases) are especially scrutinized, so caution is key.

The second mistake is avoiding documentation. Without documentation, the IRS can argue that the loan was a gift from the outset. Thus, it is crucial to create a promissory note (with an attorney or CPA) that lays out the official details (date, AFR, terms, amortization schedule, and signatures). Some of our clients have even demanded a notary or witness for formality!

The third mistake is the irreconcilability of income and deductions. For example, if the borrower deducts interest as a tax benefit, the lender must claim interest as taxable income. In short, the deductibility of the interest income (Schedule A of the 1040 for borrowers) must match the interest income (Schedule B of the 1040 for lenders).

The last mistake is when the lender “forgives” the loan without reporting it. If a parent, for example, forgives a \$1,000,000 loan after a few years, they must report this amount as a taxable gift on Form 709.

In closing, when used properly, intrafamily loans can be effective planning tools used for lending, tax, and estate planning. Please consult with your CPA or estate planning attorney for tax advice. ■

¹ <https://www.freddiemac.com/pmms>

² <https://www.irs.gov/pub/irs-drop/rr-26-06.pdf>