



Intra-family loans

By Christine Kolm

Lending between family members is a common occurrence. Intra-family loans are more common among high net worth families, in part because high net worth families have a greater lending capacity. Unlike commercial loans, intra-family loans are usually motivated by a desire to benefit the borrower in some way rather than maximizing the return on the loan. For example, many intra-family loans require less (or no) collateral than traditional lenders would require, and typically charge interest rates well below what would be available in the traditional lending marketplace. While loans between family members seem relatively simple at first glance, there are a number of income, gift, and estate tax traps of which both lenders and borrowers should be aware. Fortunately most of these traps can easily be avoided by proper loan structure and administration.

Perhaps the most common form of intra-family lending is a loan from a parent to a child to help the child purchase or invest in a specific asset. Often we see parents lending to children to assist with the purchase of a home. This may allow a child to purchase a home that they might not qualify for under traditional lending standards, or ease the financial burden of debt

service by setting the interest rate below that available through conventional mortgage products. Another common use of intra-family lending is to assist children or other family members in the purchase or start-up of a business. This structure can be invaluable to a child who lacks credit history or is unable or unwilling to provide collateral associated with other types of financing.

Intra-family lending can itself be an efficient and relatively simple estate tax planning strategy, especially in low interest rate environments. With this type of lending, the senior generation lends funds to the junior generation at the lowest permissible interest rate, and hopes that during the term of the loan the junior generation can invest these funds and earn a return in excess of the interest rate on the loan. Any "excess return" belongs to the junior generation with no gift tax consequences, and avoids potential estate tax in the senior generation's estate. Because the junior generation's interest payments to the senior generation are typically taxable income, this type of loan is often made to an irrevocable trust for the benefit of the junior generation with the trust structured as a grantor trust for income tax

purposes. If properly structured, this eliminates the income tax on interest payments received by the senior generation.

Example

Parents lend their child \$5 million, taking back a promissory note. The note requires the child to make interest-only payments to the parents on an annual basis for nine years, with all principal due at the end of year nine. The note carries the lowest permissible interest rate (the mid-term applicable federal rate provided by the IRS for the month the loan is made), which we will assume for purposes of this example is 2.0%. If the assets appreciate at 5% annually during the nine year term, the child would have \$1,653,985 remaining after all interest payments have been made and principal repaid, potentially saving \$661,594 in estate taxes (assuming these assets would have otherwise been taxable in parent's estate at a 40% tax rate).

outstanding, and eliminates the negative income, gift, and estate tax consequences that can arise if required interest and principal payments are not made.

LOAN STRUCTURE

A primary consideration in structuring intra-family loans is avoiding "below market loan status." The concept of a below market loan is addressed in detail in the Internal Revenue Code, and classification as such generally results in very unfavorable income and gift tax consequences. Fortunately, the IRS has provided detailed guidance on how to avoid "below market" loan classification.

Around the 20th day of each month the IRS publishes the applicable federal rate (AFR) for the following month. The AFR is the minimum interest rate that must be charged on loans made during that month to avoid below market loan status. The IRS classifies loans as either term

loans, which typically have a fixed maturity date, or demand loans, which are payable in full at any time on the lender's demand. With both term and demand loans, the duration of the loan impacts the minimum interest rate that must be charged. The IRS provides

separate rates for short-term loans (three years or less), mid-term loans (more than three years but less than nine years), and long-term loans (more than nine years).

A term loan is considered below market if the amount of the loan exceeds the present value of all payments due under the loan. As a general rule, below market status can be avoided by simply charging at least the AFR in effect for the month the loan is made. The

Year	End of year loan balance	Beginning of the year trust value	5% income and appreciation*	Interest and principal to parents	End of year trust value
1	\$5,000,000	\$5,000,000	\$250,000	-\$100,000	\$5,150,000
2	5,000,000	5,150,000	257,500	-100,000	5,307,500
3	5,000,000	5,307,500	226,375	-100,000	5,472,875
4	5,000,000	5,472,875	273,644	-100,000	5,646,519
5	5,000,000	5,646,519	282,326	-100,000	5,828,845
6	5,000,000	5,828,845	291,442	-100,000	6,020,287
7	5,000,000	6,020,287	301,014	-100,000	6,221,301
8	5,000,000	6,221,301	311,065	-100,000	6,432,366
9	5,000,000	6,432,366	321,618	-5,100,000	1,653,985
Remaining assets at end of nine years					\$1,653,985
Estate tax savings assuming otherwise taxable in parent's estate					\$661,594

* This is a hypothetical illustration and is not a guarantee of future performance.

Despite the many benefits of intra-family lending, there are situations where an outright gift may be a more appropriate solution. In situations where the lender does not need to be repaid or the borrower's ability to pay interest or principal is in question, it may be better for the lender to simply make a gift of any needed funds using a portion of their lifetime exclusion or annual gift tax exclusion. The gift eliminates having the value of the note included in the lender's estate if death occurs with the note

minimum rate on a term loan can generally apply for the duration of the loan if desired, which is appealing because it simplifies the calculation of required interest and principal payments. In periods of low interest rates, it may be advantageous to structure loans as term loans to lock in a relatively low AFR.

A demand loan is considered below market if interest is payable at a rate less than the AFR. Establishing the minimum interest rate for demand loans is more complex than that of a term loan because the rate is not fixed and must be adjusted over time as AFRs change each month. Failure to structure the demand loan to adjust as interest rates increase can result in below market status in months where the AFR exceeds the interest rate of the loan.

In summary, below market status can generally be avoided by charging a minimum interest rate at least equal to the appropriate AFR.

RISKS AND BEST PRACTICES

The IRS is skeptical of intra-family loans and presumes that all transfers in the intra-family context are actually gifts. This presumption can be overcome provided the lender can demonstrate that the transfer was an actual loan with a real expectation of repayment and an intention to enforce the debt. The following are best practices to keep in mind when considering intra-family lending:

- Intra-family loans should always be evidenced by a promissory note signed by both the lender and the borrower that spells out the amount of the loan, interest rate, due date and repayment schedule. Both the borrower and the lender should reflect the loan as their asset or liability on any personal financial statements they maintain or prepare.
- Loans should call for an interest rate at least equal to the appropriate AFR needed to avoid below market loan status. Consider structuring the loan as a term loan rather than a demand loan to avoid the complexity and hassle of floating interest rates.

- Be cautious about pre-arranged plans for the lender to forgive note payments each year using the annual gift tax exclusion. Although this often occurs, it may support an argument that the lender never expected repayment and the transfer was in reality a disguised gift.
- Consider requiring the borrower to provide collateral for the loan.
- Do not lend to borrowers who do not have the ability to repay the loan.
- In structuring the loan, discuss with an accountant or tax advisor the potential income tax consequences of a loan that accrues interest. It is generally simpler to require annual interest be paid to the lender rather than accrued.

OTHER CONSIDERATIONS

Unlike commercial loans, intra-family loans have the potential to give rise to family conflict. Parents lending money to a child should consider how other children or family members will view this assistance, especially where parents have a strong desire to treat children equally. Parents should also consider how they would want any unpaid principal and accrued interest handled in the event of their death during the term of the loan. Generally the outstanding note balance and accrued interest is an asset of the estate, which ultimately gets distributed according to the estate plan. Alternatively, some parents prefer to forgive any debt outstanding at death as a gift under their will or revocable trust. Lastly, potential lenders should be aware of any state law considerations such as promissory note execution requirements or a state intangible tax on debts (for example, Florida's documentary stamp tax on certain debt evidenced by promissory notes). Your legal advisor should be able to help guide you through these potential issues.

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