

Estate Planning Issues With Intra-Family Loans and Notes

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I. SIGNIFICANCE

- A. Examples of Uses of Intra-Family Loans and Notes. Wealthy families often run a “family bank” with advances to various family members as they have liquidity needs. Many of the uses of intra-family loans take advantage of the fact that the applicable federal rate (“AFR”) is generally lower than the prevailing market interest rate in commercial transactions. (The AFR is based “on outstanding marketable obligations of the United States.” The short-term, mid-term, and long-term rates under §1274¹ are determined based on the preceding two months’ average market yield on marketable Treasury bonds with corresponding maturity.²) Examples of possible uses of intra-family loans and notes include:
1. Loans to children with significant net worth;
 2. Loans to children without significant net worth;
 3. Non-recourse loans to children or to trusts
 4. Loans to grantor trusts;
 5. Sales to children or grantor trust for a note;
 6. Loans between related trusts (e.g., from a bypass trust to a marital trust, from a marital trust to a GST exempt trust, such as transactions to freeze the growth of the marital trust and transfer appreciation to the tax-advantaged trust);
 7. Loans to an estate;
 8. Loans to trusts involving life insurance (including split dollar and financed premium plans);³
 9. Home mortgages for family members;

* Copyright 2012 by Bessemer Trust Company, N.A. All rights reserved. Portions of this article, in particular Sections IV-X (the intricacies of §7872), Section XVIII (income tax effects of installment sales under the §§ 483, 1274, and 7872 rules), and Section XX (SCINs) are based on (and in large part taken verbatim from) outstanding articles by Philip J. Hayes. Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners*, 13 CALIF. TR. & EST. QUARTERLY 5 (Summer 2007)(permission granted for the use of portions of this article); Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness, Part 2: Intra-family Sales for Beginners*, 13 CALIF. TR. & EST. QUARTERLY 15 (Fall 2007)(permission granted for the use of portions of this article); Philip J. Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness*, ABA REAL PROP., PROB. & TR. L. SECTION SPRING MEETING (2007).

¹ References to a “§” in the text will be to sections of the Internal Revenue Code of 1986, as amended.

² See Whitty, *Effects of Low Interest Rates on Investment-Driven Estate Planning Techniques*, 30 EST. PL. 587 (Dec. 2003).

³ The split dollar regulations provide that a premium financing arrangement will be governed by §7872, unless it provides for the payment or accrual of interest at the AFR. Treas. Reg. § 1.7872-15(a)(1). Even if the loan provides for adequate interest, if the split dollar loan is “non-recourse” (e.g., a loan to a trust with no other assets than the life insurance policy), the loan will be treated as a below-market loan under § 7872 unless the parties attach statements to their annual income tax returns representing that a reasonable person would expect all payments under the loan to be made. Treas. Reg. § 1.7872-15(d)(2)(“Each party should ... attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies”). Split dollar life insurance plans are outside the scope of this outline and will not be addressed further.

10. Loans for consumption rather than for acquiring investment assets (these may be inefficient from an income tax perspective because the interest payments will be personal interest that does not qualify for an interest deduction);
 11. Loans as vehicles for gifts over time by forgiveness of payments in some years, including forgiveness of payments in 2012 as a method of utilizing \$5.0 million gift exemption available in 2012;
 12. Loan from young family member to client for note at a higher interest rate (to afford higher investment returns to those family members than they might otherwise receive) (In a different context, the Tax Court has acknowledged the reasonableness of paying an interest rate higher than the AFR⁴); and
 13. Client borrowing from a trust to which client had made a gift in case the client later needs liquidity (and the resulting interest may be deductible at the client's death if the note is still outstanding at that time⁵).
- B. Inadvertent Loans. Loan situations can arise inadvertently. For example, assume that a client pays a significant "endowment" for the client's parent to live in a retirement facility. The facility will refund a portion of the endowment when the occupant dies. The maximum refund is 90%. Payment of the "endowment" appears to represent a 10% gift and a 90% percent interest-free loan.
- C. Advantages and Disadvantages of Loans and Notes.
1. Arbitrage. If the asset that the family member acquires with the loan proceeds has combined income and appreciation above the interest rate that is paid on the note, there will be a wealth transfer without gift tax implications. With the incredibly current low interest rates, there is significant opportunity for wealth transfer.

Example: Assume a very simple example of a client loaning \$1 million to a child in February 2012 with a 9-year balloon note bearing interest at 1.12% compounded annually (the AFR for mid-term notes). Assume the child receives a 5% combined growth and income, annually (net of income taxes-- the taxes would be borne by the client if the loan were made to a grantor trust).

Amount child owns at end of nine years (@5.0%, compounded annually):	\$1,551,328
Amount owed child at end of nine years (@1.17%, compounded annually):	<u>1,105,436</u>
Net transfer to child (with no gift tax)	\$ 445,892

⁴ Estate of Duncan v. Commissioner, T.C. Memo. 2011-255. The court's reasoning is compelling:

"Interest rates are generally determined according to the debtor's rather than the creditor's characteristics... The long-term applicable Federal rate is thus inappropriate because it is based on the yield on Government obligations... It therefore reflects the Government's cost of borrowing, which is low because Government obligations are low-risk investments... Using the long-term applicable Federal rate consequently would have been unfair to the Walter Trust. [citations omitted; emphasis in original]."

Estate of Duncan is discussed in Section XXI.B.3 of this outline, *infra*.

⁵ See Section II.D.4 of this outline, *infra*.

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