CHAPTER 35

INTRA-FAMILY LOANS

INTRODUCTION

On a superficial level, an intra-family loan is simply a loan among family members. The usefulness of the technique becomes apparent as it is applied in different situations. For example, the technique can be applied in two situations. First, where an asset is sold from one family member to another and the seller lends the buyer the money to pay the purchase price over a period of time. Second, it can come into play where money is simply loaned to another family member for whatever reason. From the lender’s perspective, it essentially “freezes” the value of the asset, because all the lender can gain after the loan is made, is the return of the principal plus a fixed rate of interest. In either situation, what is included within the lender’s estate is the (sometimes discounted) value of the note. Any appreciation in the value of the asset which is sold, or the investment which is made with the loan proceeds, takes place outside the seller’s estate. Therefore, the seller’s value is “frozen” to its value at the time of the transaction and the growth in the asset occurs in the family-member buyer’s hands.

Another benefit of this structure is that the payment of interest can result in income tax shifting among the family. This occurs if the loan is structured with a trust which allows the income to be spread among (and taxed to) a group of family members in lower tax brackets. If the note is with a so-called “defective grantor trust”, the seller will be taxed on both the interest expense and the interest income. In these situations, the payment of the interest will be a neutral event to the seller, subject to any limitations on the seller’s ability to claim the interest expense as a deduction. In essence, the seller is making a gift free of the tax he/she pays to the other family members involved in the transaction.

WHEN IS USE OF SUCH A DEVICE INDICATED?

One of the primary benefits of using this wealth-shifting technique is to allow the seller to remove an appreciating asset from their estate. In these situations, the seller can sell the asset to the seller’s child, or a trust for the child’s benefit. Ideally, the asset would be income producing so that the purchaser (i.e. the trust or the child) will be able to fund the payments to the seller with the income produced by the asset. This technique can also be used to transfer an interest in a business. Another benefit to the seller in retaining a promissory note is that this arrangement permits the seller with the ability to indirectly tap into the equity of an asset. This equity will provide a cash flow stream to the seller, who may use these funds as a part of his or her retirement income.

A loan can also be useful if the younger generation is going to make an investment which will likely produce a greater rate of return than the interest rate which must be charged under IRS guidelines (i.e. Applicable Federal Rate, or AFR). Therefore, if the family were to pursue a new venture or investment, it may be advisable to lend the money to the younger generation so that they can make the investment and it can grow in their hands rather than in the senior member’s estate.

Another way the device can be helpful is if the lender wants to provide the funds to the borrower; but does not want to make this a gift. Such a technique avoids or minimizes gift tax liability by the lender. It can also be used if the lender wants to equalize distributions among the family.

For example, assume a father has two children and wants to treat them equally. One child wants $100,000 to purchase a house. If the father gifts the money to that child, the estate is reduced by the amount of the gift. Then, if the father dies, this reduced estate is divided equally, and one child has received more than the other. However, if the funds are advanced to the child in the form of a loan; while the father’s estate is reduced by the amount of the cash, the cash (as an asset) has been replaced with a loan receivable. Therefore, the estate can still be distributed equally between the children, because the father’s loan receivable from the one child can then be allocated to that child’s share of the estate.

WHAT ARE THE REQUIREMENTS?

Since the parties are attempting to establish a lender – borrower relationship, it is essential to adhere to and document compliance with the formalities of this arrangement. The Tax Court has reviewed this issue and provided guidance as to how to determine if the loan is bona fide. Courts have noted that a key characteristic of a loan is the intention of the parties that the debt be repaid. In making this determination, there are certain relevant factors to help determine if this test is satisfied. The factors are non-exclusive, and no one is determinative of the issue. These factors are an indicia of a bona fide loan upon which the courts may analyze the transaction.[[1]](#endnote-1)

1. Whether the promise to repay was evidenced by a note or other instrument.

Applicable state law may not require that the debt be in writing in order for it to be enforceable. If the terms of the obligation can be established through other means, a court may still enforce the obligation. However, that is in third party enforcement cases. When trying to establish a transaction for tax purposes, it is important to have the appropriate written documents. This is especially true with intra-family transactions. These transactions receive additional scrutiny. The presumption is that the transfer between family members is a gift. However, this presumption may be rebutted by an affirmative showing that there was a real expectation of repayment and an intention to enforce the debt.[[2]](#endnote-2)This is why it is some important to document the understanding.

2. Whether interest was charged.

In a typical arms-length transaction, a lender would typically charge interest. The question then becomes, “What is the appropriate rate of interest?” The interest rate must be no lower than the Applicable Federal Rate (AFR) for the month in which the loan was entered into. The AFR which to be applied is based upon the term of the loan. A short term loan is for up to three years. From three years to nine years, the mid-term rate applies. The long term rate applies for loans more than nine years. The AFR is issued monthly by the IRS in a Revenue Ruling and can be obtained for free at http://www.leimberg.com/freeResources/keyRates.html.

3. Whether a fixed schedule for repayment was established.

In a bona fide loan transaction, there will be a schedule of payments which will be honored. It is important to follow the formalities of the transaction and make the payments when due. The failure to enforce a default would be relevant in determining that it was not a real loan.

4. Whether collateral was given to secure payment.

Again, in a typical arms length transaction there would be collateral for a loan. To the extent that this collateral is against real estate, then a mortgage should be executed and recorded. For non-real estate related loans, it would be appropriate to have guarantees or other assets pledged to secure the arrangement. However, if other assets are pledged as collateral, it is important to respect the security interest associated with the assets being pledge. Therefore, these same assets should not be pledged for a different loan and with different loan having a priority in terms of its security interest.

5. Whether repayments were made.

While many times, the loans are structured to be interest only with a balloon payment some years in the future, it can be helpful in structuring the Note to include a portion of the payments being attributable to the repayment of principal. This will help establish the legitimacy of the lender – borrower relationship.[[3]](#endnote-3)

Sometimes, an intra-family loan is not structured with an individual family member; it is instead entered into with a trust for the benefit of family members. When structuring a loan with a Trust, it is important that the trust have some level of assets. If there were no assets in the trust, the IRS may view the loan as illusory. A general rule is to fund the trust with assets worth at least 10% of the value of the loan.[[4]](#endnote-4)This initial funding will constitute a gift and utilize a portion of the transferor’s lifetime exemption. If the parties do not want to fund the trust with a gift, a beneficiary can provide a personal guaranty with respect to the loan.

HOW IT IS DONE – AN EXAMPLE

The initial step would be to determine the asset to be sold. Ideally, it would be an asset with a good chance of appreciating. This would allow the future appreciation of the asset to by-pass the seller’s estate. It is also important to make sure that the arrangement will be followed. Therefore, the terms of the note should be structured so that there will be no problem in following its provisions.

For example, Bob wants to sell to his daughter, Mary, a condominium which Bob has been renting out. The tenant pays $600 per month and the property has been appraised for $100,000. If Bob sells it to Mary pursuant to a 15 year note at 4%, the monthly payments will be $739.68. If the note is for 30 years, the payments decrease to $477.42. Therefore, since the rent is $600 per month, the terms of the loan will have to be for a longer period then 15 years. It is necessary to determine how long to make the loan period so that the cash flow will make the structure work.

This analysis only considered the amount of the mortgage. The other expenses associated with the operation of the property will also have to be taken into account. These expenses will include the condominium fee, utilities, taxes, and an allowance for maintenance. In addition, the amount of any income tax associated with this stream of payments will also have to be considered.

 Depending upon how the cash flow analysis works, it may be necessary to have a portion of the property be treated as a gift; thereby reducing the amount that needs to be financed. The important point is that the structure of the transaction should take into account the amount of the cash flow necessary to follow the terms of the arrangement. It is important that Mary, in our example, have a reasonable prospect of having the ability to service the loan.

TAX IMPLICATIONS

The tax implications are broken into two parts: first, the payment of interest; and second, the payment of principal. As indicated above, the minimum interest rate which must be charged is based upon the AFR. Generally, the lender must recognize interest income; the borrower will recognize the interest expense. There are certain exceptions to this minimum interest requirement, but these relate to loans under $100,000 and $10,000. See Chapter 38.

However, if the loan is structured with a grantor trust, then the seller is treated as both paying and receiving the interest. Subject to any limitations on the ability to claim the deductions, there should be no income tax consequences as to the interest and principal while the grantor is alive. See Chapter 27.

With respect to the repayment of principal, the tax consequences will somewhat depend. If the principal was due because of a loan of cash, there are no tax consequences as to the repayment because this is simply a return of capital. If the principal is being paid because of a sale of property, then there may be capital gains tax associated with these payments.

Generally, these repayments of principal will qualify for installment sale treatment. See Chapter 36. Installment sale treatment permits the seller to recognize the capital gains as the payments are received. However, transactions will not qualify for installment sale treatment. For example, installment sale treatment does not apply to dealer disposition (IRC Sec. 453(b)(2)), sales of inventories of personal property (IRC Sec. 453(b)(2)), sales of depreciable property to related persons (IRC 453(g)), depreciation recapture (IRC Sec. 453(i)), and the sale of marketable securities (IRC Sec. 453(k)(2)).

If the seller dies during the term of the note, the note is considered to be IRD. Therefore, the value of the note is included within the estate and there is no step up in basis.

However, while the value of the note will have to be included within the estate, the value may not be equal to the face value of the note. Depending upon the terms of the note and credit worthiness of the borrower, it may be possible to have the note be valued at less than its face value. It is important to have a qualified appraiser determine the appropriate level at which to value the note.

FREQUENTLY ASKED QUESTIONS

**Question** – Can the terms of the note be changed after it is established?

*Answer* – Yes, the terms of the note can be changed. However there are certain tax issues which should be considered. From an income tax perspective, a modification of a note can be treated as a disposition under Reg. Sec. 1.1001-3. Under this Regulation, a significant modification is treated as a sale and exchange of the two instruments. With respect to changes in the interest rate, Reg. Sec. 1.1001-3(e)(2) provides that if the yield changes more than the greater of: ¼ of one percent (25 basis points); or 5 percent of the annual yield of the unmodified instrument (.05 x annual yield).

From a gifting perspective, if the interests meet the IRS AFR, then there should not be any gift tax consequences. However, if the debtor was not credit worthy, it would not make sense to reduce the interest rate. Therefore, the facts and circumstances may indicate whether or not the modification resulted in a gift.[[5]](#endnote-5)

**Question** – Can someone make a promise to make a gift?

*Answer*– Toward the end of 2012, there was a lot of concern that the estate tax exemption of $5,120,000 in 2012 ($5,200,000 in 2013, $5,340,000 in 2014 and $5,430,000) would be reduced to $1,000,000. One planning idea was based upon the thought of permitting a client to make use of their estate tax exemption without relinquishing the assets. In this context, a planning concept arose whereby an individual could make a legally binding *promise* to pay pursuant to a promissory note. Assuming the note was legally enforceable under state law, the thought was that this possibly constituted a completed gift.[[6]](#endnote-6)

CHAPTER ENDNOTES

1. . Welch v. Comm., 85 AFTR 2d 2000-1064 (204 F.3d 1228), (03/01/2000). [↑](#endnote-ref-1)
2. . Elizabeth B. Miller et vir v. Commissioner, TC Memo 1996-3 (01/11/1996). [↑](#endnote-ref-2)
3. . These requirements are set forth in Frederick D. Todd, II, et ux.v. Commissioner, TC Memo 2011-123 (06/06/2011); however, very similar requirements are also set forth in *Elizabeth B. Miller et vir v. Commissioner*, supra. See also, Tax Court Reviews What Constitutes a Real Loan, Howard M. Zaritsky, Estate Planning Journal, Volume 38, Number 09, September, 2011. [↑](#endnote-ref-3)
4. . Role of Guarantees and Seed Gifts in Family Installment Sales, Martin M. Shenkman, Estate Planning Journal, Volume 37, Number 11, November, 2010. The article discusses of providing adequate capitalization for the trust and the extent to which it is necessary to have guarantees from the beneficiaries to support the obligations. [↑](#endnote-ref-4)
5. . Planning for Lifetime Wealth Transfers in an Era of Lost Value – Part 2, M. Read Moore and Lauren A. Geoffrey, Estate Planning Journal, Volume 37, Number 02, February 2010. [↑](#endnote-ref-5)
6. . LISI (Leimberg Information Services, Inc.), Estate Planning Newsletters #s2034; 2001; 2022; and 2033. [↑](#endnote-ref-6)