

Family Wealth Transfer Strategy #1 - Family Loans

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July 2009

While the low rates of return may have put a damper on the investment climate, intra-family loans have become a popular way to take advantage of the low interest rates by allowing a shifting wealth to lower-generation family members with a minimum of tax consequence.

Using an intra-family loan, an individual can provide a financial resource to their heirs for a specific use or to create a trust for their benefit. The rates used for these intra-family loans are typically more attractive than what may be available in the open market. Additionally, these loans can offer more flexibility than a commercial-type loan, with payment terms being structured based on the specific needs and circumstances of the heir or their need for the funds.

Unlike a commercial loan, an intra-family loan can come with no limitation on how a borrower uses the proceeds. An heir may use the loan to fund an investment opportunity that outperforms the interest rate. This would include helping an heir start a business, pay down a higher interest rate, or even finance a home. However, it is imperative that all parties involved understand the loan must, in fact, be repaid at some time in the future.

To understand how an intra-family loan works, you need to understand a few IRS rules. These type loans must be at or above the applicable federal rate (AFR). This rate is set monthly by the Internal Revenue Service (and is presently at historic lows). The rates for June of 2009 are broken down as follows: There are short-term rates (for less than three years) at .75%; there are mid-term loan rates from three to nine years at 2.25%; and then there are long-term loans for nine years or longer at 3.88%.

Given today's low interest rates there is a good probability that the rate of return earned on the investment will exceed the loan interest rate, allowing the appreciation to then pass to the borrower free of gift, estate, and other transfer taxes. For example: If you loan \$1 million to an heir (or to a trust established for their benefit) with a five-year term, and you assume an annual rate of return of 8%, your heir (or the trust) would retain any earnings over the 2.25% (mid-term rate for five years) or more than \$322,500 (compounded) by the end of the loan without triggering any gift, estate, and/or transfer taxes.

In addition, the loan can be structured in ways that can add other benefits. For instance, the note can be a balloon note requiring interest-only payments during the duration of the loan. In addition, it can be set-up so that the schedule of re-payments, including interest and principal, can be part of the \$13,000 annual gift tax exclusion to the beneficiary or heir. Note, however, the loan requires the documentation be in accordance with a normal business transaction, which would include a written promissory note and a tracking of the payments. Proper documentation is necessary in case the IRS reviews the transaction and tries to reclassify the loan as a gift. Further, as long as there is no immediate medical concerns, the remaining balance of the loan can be forgiven at your death through your Last Will and Testament.