

Low Interest Rates Make Intra-family Loans Appealing

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U.S. Treasury interest rates are at historic lows. Low rates are certainly disheartening for investors looking for income, but they also drive down key rates used in estate planning—a great benefit to those looking for low or no tax techniques for transferring wealth to family members. The effect of low treasury rates has reverberated throughout the fixed income markets, bringing market-wide declines in all interest rates at a time when investor insecurity about risk and equity markets is at near historic highs. Some investors believe that there is no truly “safe” investment; certainly not one that produces any income. However, as advisors, we can help our clients in this situation.

After making certain that clients’ immediate needs for liquidity are addressed and satisfied, we should evaluate the opportunities presented by the current financial environment.

For clients interested in transferring wealth to their heirs, opportunities abound when interest rates decline. This article will focus on intra-family loan transactions only. We refer you to the article “Many Estate Planning Strategies Provide Benefits in Low-Interest Rate Environment,” by Randy Gardner, Julie Welch and Leslie Daff (*Journal of Financial Planning*, October 2008, page 44) for a discussion of other wealth transfer techniques that provide benefits when interest rates decline. Like the strategies featured in that article (e.g., Grantor Retained Annuity Trusts, Charitable Annuity Trusts, Installment Sales to Intentionally Defective Grantor Trusts, etc.), a loan is a more effective means of transferring wealth when interest rates are low. Unlike those strategies, the wealth transfer from intra-family loans can be somewhat predictable, and is not necessarily dependent on stock or real estate market performance. Less exotic, but perhaps less risky as well.

Background

The idea of transferring wealth to junior family members through loans is not a new one. Parents and grandparents often lend money to junior family members using low or no-interest loans. Before 1984, the gift of the interest that the child would otherwise pay (“...the usual local rate of interest...”¹) was generally recognized as a gift, measured by comparing the value of the term note as written to that of a comparable note. For demand notes, the gift was the annual right to use money interest-free.

The taxation of intra-family loans changed in 1984 with the enactment of Internal Revenue Code Section 7872 (§7872). What §7872 did was impose an additional income tax effect on some intra-family loans. In a gift-loan situation for both demand notes and term notes, the low or no-interest aspect of the loan is re-characterized annually as two transactions:

1. the donor-lender is deemed to make a gift to the donee-borrower of the funds with which to pay some or all of the interest on the loan, and
2. the donee-borrower pays the donor-lender interest in the same amount which is taxable income to the lender and an expense for the borrower.²

In addition, for notes with a stated term, a gift occurs on execution of the note if the interest rate charged is less than the appropriate applicable federal rate. Prior to §7872, the income tax effects of the loan were not well recognized or uniformly applied. A result of the enactment of §7872 though was the establishment of floor interest rates for intra-family loans at the applicable federal rate, rather than the higher “usual local rate of interest” that had previously been used to value the gift element in the loans.

The Applicable Federal Rate

The key to transferring wealth through intra-family loans is the applicable federal rate, or AFR. The AFR is the rate at which the loan will be evaluated for both income and gift tax purposes. If a note requires a child to pay a parent no interest or an interest rate that is less than the appropriate applicable federal rate, the transaction will be characterized, at least in part, as a gift from the parent to the child and the income tax effects described above will occur. The caveat is also true. If the stated interest rate is at least the AFR, there is no gift element in the transaction, unless the interest is not in fact paid.

AFRs are determined by the IRS each month.³ The rates vary depending on the term: short-term for obligations due in less than three years, long-term for those due in more than nine years, and mid-term for everything in between.⁴ Applicable federal rates are by no means market rates. They are based on the rates for various treasury securities during the previous month. These rates are almost always less than commercial or retail rates and therein lies their great appeal with today's low treasury rates.

The applicable federal rates have never been this low. July, 2003 was the most recent period with low rates, when the annual mid-term declined to 2.55 percent.⁵ The all-time highest rate was in May of 1989 when the mid-term rate peaked at 9.73 percent.⁶ The January, February, and March 2009 applicable federal rates (annual compounding)⁷ are shown below:

Long-Term	Short-Term	Mid-Term
January 3.57%	0.81%	2.06%
February 2.96%	0.61%	1.65%
March 3.52%	0.72%	1.94%

So what can a client do when rates are this low? Simple interest rate arbitrage will transfer wealth with very little risk.

Example 1

In February, 2009, Mary loans \$200,000 to Grace, her granddaughter, for a five-year promissory note requiring annual interest at 1.65 percent. Grace invests in a five-year Certificate of Deposit (CD), earning 2.8 percent per year.⁸ Over five years, the CD will pay \$28,000 in interest. Grace pays interest of \$16,500. The difference, \$11,500, is a tax-free wealth transfer from Mary to Grace.

Mary could have purchased the 2.8 percent CD herself, and made gifts to Grace of \$11,500; instead she facilitates Grace's investment and in effect transfers \$11,500 to Grace with no gift or generation skipping tax consequence. If Grace bought an investment earning 5 percent, after five years she would have received \$50,000 and paid Mary \$16,500, a transfer of \$33,500, exempt from both gift and generation skipping tax.

Example 2

Brett and Susan have a 30-year \$300,000 6.5 percent mortgage. They have only 5 percent equity in the house. Their current payments are \$1,896 per month. The low equity has impeded re-financing to a new 30-year mortgage a lower rate.

Susan's parents, Mike and Clare, have a \$500,000 CD maturing in February 2009. They could roll-over the CD and earn 2.8 percent⁹ per year for five years. Or, they could become lenders by re-financing the \$300,000 30-year mortgage at 3 percent, which would reduce the kids' monthly principal and income payment to \$1,265. Over the life of the mortgage, Brett and Susan would save \$227,301, compared to their current debt.

Since 3 percent is more than the February, 2009 long-term AFR of 2.96 percent, this wealth transfer is not a gift for tax purposes. Mike and Clare will receive annual principal and interest payments of \$15,180. The 3 percent rate is more than they can currently get from a CD, but they are sacrificing the returns they may get from future interest rate increases. Brett and Susan are unlikely to pre-pay a 3 percent mortgage, so this is a permanent freeze of income for Mike and Clare at a low rate. The wealth transfer here is the future income, most likely higher than 3 percent, that Mike and Clare could earn on the funds they loan to Brett and Susan.

Appreciating Assets

These are just two examples of fairly simple wealth transfers taking advantage of low AFRs. Even greater wealth might be transferred if the borrowed funds were invested in appreciating assets. Intra-family loans achieve transfers of earnings and, depending on the use of the borrowed funds, appreciation. They do not achieve estate reductions since the principal of the loans remains part of the lender's estate. These transactions are appropriate only for families with excess cash or other liquid assets. It is not advisable for parents to risk their own future financial security solely to transfer wealth to a child.

What if clients already have loans to their children and grandchildren; can these loans be re-financed free of gift tax? Most intra-family promissory notes do permit penalty-free prepayments. If the child-borrower could actually repay the note and then re-borrow, that fact pattern would be no different than re-financing a mortgage and would not be a gift. But in many family loans, the child doesn't have current assets to actually repay the loan. Whether there is a gift when an intra-family note is replaced with only a lower rate note and no other consideration is a matter of some disagreement among planners and taxation consultants.¹⁰ Those in the more conservative camp recommend changing the contractual provisions of the note, perhaps shortening the payment term somewhat to create a benefit to the lender that could reasonably justify reducing the interest rate.

Tax Considerations

The IRS looks at intra-family loans carefully due to the overarching potential for gifts in these situations. For tax purposes, a gift occurs whenever there is a transfer for insufficient consideration.¹¹ It is important to be aware of what factors support a finding of sufficient consideration. Charging an appropriate interest rate¹² for the transaction is one factor, even if that rate is less than a market interest rate.¹³ Therefore, observance of proper loan formalities is very important. There should always be a signed promissory note. The note may be either a demand note or term provide a specific term. A specific term is necessary to secure the certainty of a specific AFR, key to the interest rate arbitrage we have discussed. If the loan is a home mortgage, it must be secured by the home for the payer

to obtain a home mortgage interest deduction and should be secured anyway to protect the lender's investment. Similarly, a family lender should require proof of insurance to protect the investment. For non-residential loans, providing collateral for the loan would be appropriate. Actual timely payments by the borrower to the lender are also recommended. Many families dispense with actual payments relying on the annual exclusion (\$13,000 per donee per year) to "cover" the imputed interest. Actual cash payments provide a better audit trail for the payer to document a tax deduction. If the payer can't make payments without assistance in the form of gifts, separate the transactions in time and amount, i.e. don't just exchange checks. If the borrower can pay the monthly payments, annual exclusion gifts could be applied to forgive some note principal. Loan forgiveness gifts should be documented in writing as well.

Additional Benefits

The benefits of intra-family loans are not limited to wealth transfers. These loans provide an opportunity for parents and grandparents to help younger generations obtain financing without administrative burdens and fees. Older generations retain some cash flow. There is certainly no requirement that the rate charged be as low as the AFR, it simply cannot be lower without an element of gift. Many families charge rates that are higher than the AFR but lower than market rates to even-out the benefits between generations. Helping children and grandchildren with home mortgages can make a truly meaningful contribution to junior family members' ability to build wealth or weather a short-term financial emergency such as a loss of employment. While Mike and Clare in Example 2 above give up current and future return on the money loaned to their daughter, they also get a benefit from knowing that their child is building equity in her home and enjoying a more comfortable lifestyle with smaller monthly mortgage payments. Younger generations have the chance to prove financial responsibility to both themselves and the older generation by making timely payments.

It is unlikely that treasury rates will remain as low as they currently are. This means that applicable federal rates will also increase. Don't miss this opportunity to present your clients with a flexible and easy to understand wealth transfer technique.

Footnotes

1. *Gertrude H. Blackburn v Commissioner*, 20 T.C. 204 (1953), PLR 7905090, 11/02/1978
2. IRC §7872(a)
3. IRC §1274(d)
4. *Ibid.*
5. Rev. Rul. 2003-71, 2003-2 C.B. 1
6. Rev. Rul. 89-65, 1989-1 C.B. 245
7. January, Rev. Rul. 2009-1, 2009-2 IRB 248; February, Rev. Rul. 2009-5, 2009-6 IRB 432; March, Rev. Rul. 2009-8, 2009-10 IRB (to be published March 9, 2009.)
8. 5-Year CD National Overnight Average, www.Bankrate.com 2/10/09
9. *Ibid.*
10. Favoring altering promissory note terms when re-financing is Benjamin N. Feder in "The Promissory Note Problem," *Trusts and Estates*, January 2003. Proponents of the position that substituting intra-family notes with different interest rates is not a gift are Jonathan G. Blattmachr, Elizabeth O. Madden, and Bridget Crawford in "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for Higher AFR Note," *Journal of Taxation*, July, 2008.
11. IRC §2512
12. IRC Sections 483, 1274, and 7872 all provide rules governing appropriate rates of interest for various transactions. §483 provides rules for sales of property when payment is deferred for more than one year. §1274 governs all other notes issued in exchange for property. §7872 governs below-market loans, generally in gift or compensatory situations.
13. Proposed Regulation 25.2512-4