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Estate Planning alert

TAX ALERT
Intra-Family Loans: An Important Wealth Preservation Planning Technique

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You can make a loan to a family member at a significantly lower interest rate than that currently charged by commercial lenders. In this manner, you can shift wealth to another family member in a very tax efficient manner.

In order to prevent the IRS from treating an intra-family loan as a taxable gift, you must charge a certain minimum interest rate, which is known as the applicable federal rate ("AFR"). The AFR on the date the loan is first made can be locked in as the applicable interest rate for the entire term of the loan.

The United States Treasury determines the AFR every month, and currently the AFR has been at historic low rates. The minimum interest rate required to be used depends on the term of the loan. In October 2012, if interest is paid annually on a loan, the AFR for short-term loans (loans for up to three years) is 0.23%. The AFR for mid-term loans (loans over three but not over nine years) is 0.93%, and the long-term AFR rate for loans over nine years is 2.36%.

To the extent that interest charged on a loan between family members is lower than the AFR, that amount will be imputed as income to the lender, even though the lender does not actually collect it. In addition, the IRS will treat that amount as a gift to the borrower, which may require the filing of a gift tax return, and possibly the payment of gift tax. However, if you make the loan using an interest rate equal to the AFR, no such adverse tax consequences should occur.

If a family member receiving such a loan is able to earn a higher rate of return on the borrowed funds than the interest rate being charged, he or she will be able to keep the excess without any gift tax consequences. The loan can be structured with a “balloon payment” which allows the borrower to pay interest only during the term and does not require repayment of any principal until the end of the term.

For example, if a parent makes a nine-year loan in October 2012 to a child of $500,000, the loan will result in a transfer of wealth to the next generation if the child can earn over 0.93% with the money borrowed. If the child invests the $500,000 for the nine years at a 5% annual rate of return, the child will have $775,664 at the end of the term, and will only have to repay his or her parents $541,850 throughout the term of the loan. Therefore, the child is entitled to keep the difference of $233,814 without any gift tax consequences. If the parent was going to make the same investment that the child made anyway, the risk to the family as a whole has not changed and the loan was a successful way to transfer wealth to the next generation in a tax efficient manner.

Intra-family loans also may be more beneficial than third-party loans because they allow the total interest expense paid over the term of the loan to stay within the family rather than being paid to a bank. In addition, an intra-family loan can allow a family member who has poor credit history to buy a home or to start a new business. Families can avoid the normal expenses incurred with commercial loans, such as administrative costs, closing costs and appraisal fees. If a child wants to pay off the loan early, the terms of the loan can be structured so that there are no prepayment penalties.

To avoid any misunderstandings and tax problems down the road, an intra-family loan should be carefully documented with a formal legally binding promissory note.

In summary, intra-family loans can be a simple but efficient estate planning tool. Please contact our office at 215.661.0400 if you have any questions or want to learn more about intra-family loans or other wealth preservation planning techniques.