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INTRA-FAMILY LOANS **ANOTHER POWERFUL WEALTH TRANSFER TOOL** **FOR THE LOW-INTEREST-RATE ENVIRONMENT**

In the current low-interest-rate environment, intra-family loans are a simple yet very effective estate planning strategy for transferring substantial assets to the next generation with minimal gift tax. Intra-family loans are designed to “freeze” the value of the transferred assets and shift income and appreciation of the assets in excess of the published interest rates to children or more remote beneficiaries with little or no gift tax.

Intra Family Loans

One of the most basic forms of an intra-family loan would be for a parent to lend funds to a child at the lowest interest rate that is allowed under the Treasury Department’s safe harbor rates for loans. This rate is more commonly known as the applicable federal rate (“AFR”). The AFRs for the month of May of 2009 are as follows:

- # Short-term loans (up to 3 years) 0.76%
- # Mid-term loans (more than 3 years and up to 9 years) 2.05%
- # Long-term loans (more than 9 years) 3.52%

Advantage

If the total return on the assets loaned to a child exceeds the interest rate charged on the loan (i.e. AFR), the excess will be transferred gift tax-free to the child. In light of the recent contraction in asset values, now is a very opportune time to explore this estate planning technique. With such a low AFR, and deflated asset values, the possibility of having a positive result has never been better.

Income Tax

The lender (the parent) would report interest payments as income and, generally speaking, the recipient of the loan would be able to deduct the interest payment for income tax purposes if the loan is made in connection with the acquisition of a principal residence or an investment that produces taxable income.

Loans to Trusts

The lender (parent) may also make a low interest rate loan to a new or existing trust for the benefit of family members. The trust can be drafted as a “dynasty trust” or generation-skipping trust that is designed to benefit multiple generations of family members. The trust, however, should hold sufficient assets other than the proceeds from the loan so that the IRS respects the loan transaction and does not recharacterize the loan as a gift.

Loans to Grantor Trusts

The trust to which the loan is made may and often should be drafted as a “grantor trust”. This means the trust would be treated as the grantor’s alter ego for income tax purposes and all income and capital gains earned by the trust would continue to be reported on the grantor’s individual income tax return. This payment of income taxes by the grantor is an indirect non-taxable gift to the trust (and children) and allows the trust to grow income-tax free. In addition, a loan by the grantor to the trust will have no income tax consequences, so that the grantor will not report the interest as income and the trust will not deduct the interest.

Example:

The major indices in the equity markets have recently appreciated by approximately 30% on average since hitting the lows during the recent financial market meltdown. If an individual had sold \$10 million in securities to a family member or a grantor trust in exchange for an installment note, then the \$3 million in appreciation on the sold assets would escape estate taxation; thus, netting estate tax savings of approximately \$1.5 million on the transaction: very simple, yet very effective!

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