Proskauer

Lowered Interest Rates Due To Coronavirus Makes Intra-family Loans an Effective Estate Planning Tool

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As a result of the Federal Reserve Bank's recent stimulus and interest rate decreases in response to the coronavirus, intra-family loans can be used to transfer wealth to future generations with no gift tax consequences as well as to renegotiate existing intra-family loans at reduced interest rates.

An intra-family loan is a basic estate-planning technique which has a very low transaction cost. Uncertainty around coronavirus and continued decreases in the market highlight the effectiveness of this simple tool and corresponding wealth-transfer. Under rules set forth in the Internal Revenue Code, it is possible to make loans to family members at lower rates than those charged by commercial lenders without it being deemed a gift. As discussed below, the lender, usually a parent or grandparent, must charge interest in order to avoid making a gift to the borrower. However, this interest rate may be as low as 0.99% for a loan for a term of three to nine years, with interest paid annually, made in April 2020. The lender can also structure the loan as a balloon note meaning that the borrower pays only interest during the term of the loan and only repays the principal at the end of the term.

Economic Benefits of Intra-family Loans

If a parent makes an interest-free loan to a child or grandchild, the Internal Revenue Service ("IRS") will treat the foregone interest as a taxable gift. In order to prevent the IRS from treating a part of the loan itself as a gift, the parent must charge a certain minimum interest rate, which is known as the applicable federal rate ("AFR"), which the Treasury determines every month. To the extent that the interest charged on the loan is lower than the interest calculated with the AFR, that amount will be imputed income to the parent, even though the parent does not actually collect it. Furthermore, the IRS will treat that amount as a gift to the child, which would require the filing of a gift tax return. However, if a parent establishes a bona fide creditor-debtor relationship with adequate stated interest, the intra-family loan will not be characterized as a transfer subject to the gift tax.

Intra-family loans allow a shift of wealth from one family member to another family member, usually a child or grandchild, if that child or grandchild can earn a greater return on the amount borrowed than the AFR. The minimum interest rate required to be used depends on the term of the loan, and the compounding period. In April 2020, if interest is paid annually on a loan, the AFR for short-term loans (demand loans and loans for up to three years) is 0.91%. The AFR for mid-term loans (loans from 3-9 years) is 0.99%, and the long-term AFR rate for loans over 9 years is 1.44%. To the extent that a child or grandchild is able to earn a higher rate of return on the borrowed funds than the interest rate being paid, he or she is able to keep the excess without any gift taxes being paid.

For example, if a parent makes a nine-year loan to a child of $2 million, the loan will be a successful estate planning tool if the child can earn over 0.99% with the money borrowed. If the child invests the $2 million for the nine years at an 8% annual rate of return, he or she will have about $3,998,009 at the end of the loan, and will only have to repay his or her parents $2,185,422 throughout the course of the loan. Therefore, the child is entitled to keep the difference of $1,812,587 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.

Other Benefits

Outside of a wealth transfer concept, intra-family loans may also be more beneficial than third party loans because they allow the total interest expense paid over the course of the loan to stay within the family rather than being paid to a bank. In addition, an intra-family loan can allow children who have poor credit history to buy a home or to start a new business. Furthermore, it allows families to avoid the normal expenses incurred with loans, such as administrative costs, closing costs and appraisal fees. Also, if a child wants to pay off the loan early, the terms on the loan can be structured so that there are no prepayment penalties.

The amount of savings for children who are looking to buy a house can be significant. For example, according to Freddie Mac, as of March 12, 2020, the average bank rate for a 30-year fixed mortgage rate is 3.36%. A $500,000 mortgage at 3.36% would require one to pay $2,206 a month. However, a mortgage at the long-term AFR for April 2020 (1.44%) would only require one to pay $1,711 per month. Therefore, a child would save about $495 per month and about $5,940 per year if a parent loans him or her money to buy a home.

Additional Tax Benefits

The IRS allows any individual to make a gift to another person free of the gift tax each year up to the amount of the annual exclusion, which is currently $15,000. In addition to the annual exclusion, every person is allowed an $11,580,000 lifetime exemption from the gift tax. Therefore, even if an individual gives more than $15,000 to a single person in a given year, the gift amount which is above $15,000 will not be subject to tax unless the individual has already given $11,580,000 in taxable gifts throughout his or her life.

Because intra-family loans are not gifts, they do not count towards an individual's lifetime gift tax exemption. Therefore, even if an individual has used up all of his or her $11,580,000 lifetime exemption from the gift tax, he or she can still make a loan to a family member without paying gift tax. Furthermore, a grandparent can make a loan to a grandchild without being subject to the generation-skipping transfer tax.

In addition, an intra-family loan can be used to take advantage of the $15,000 annual exclusion. A parent can forgive up to $15,000 per year per family member (and up to $30,000 if a married couple splits the gift) without any adverse gift tax consequences. However, the parent will have interest income in any year in which interest is forgiven.

Renegotiation of Existing Loans

Many clients already have outstanding intra-family loans relating to one or more recent transactions. In light of the reduced interest rates in April 2020, there is an opportunity for those clients to renegotiate any existing loans. If done properly, the renegotiated loans can result in significant transfer tax savings in excess of the savings contemplated when the initial transaction took place. Clients who currently have outstanding intra-family loan should call Proskauer to discuss their options in this current low-interest rate environment.

Conclusion

An intra-family loan can be used as a simple and effective wealth transfer device. Such a loan is a successful estate planning tool if a family member earns a higher return on the money borrowed than the AFR, thus today's low AFR presents an opportunity to lock in a low interest rate on an intra-family loan. Additionally, clients who have existing intra-family loans may consider renegotiating those loans in order to take advantage of the current low interest rates.

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