

How to Use Market Interest Rate Loan Plans as an Estate Planning Tool

If you borrow money from a family member at less than a prescribed market interest rate (the applicable federal rate or AFR), you (the borrower) are treated as paying interest to the lender at the difference between AFR and your borrowing rate. At the same time, the lender, depending on the circumstances, is treated as making a gift of such interest to you as the borrower.

Does this mean an intrafamily loan cannot be an effective tool for transferring wealth from one generation to the next? No. Even a market rate interest loan between family members can be an effective estate planning technique in certain situations. One of the advantages of using such a loan is that the general concept is relatively simple and readily understandable. For example, a parent can lend to a child at 6% interest so that the child can invest in equity funds that grow at 15%.

Loan from Child to Parent

For example, sometimes having the child be the lender makes sense. Consider having one of your children loan money to you at an interest rate below the commercial lending rate but above the applicable federal rate. For example, if the long-term AFR is 6% and the commercial lending rate is 11%, your child might charge an interest rate of 9% or 10%. By charging an interest rate higher than the federal rate, your child, the lender, can deflect an IRS challenge to the transaction that a gift was made to you, the borrower.

If your child loans you \$1 million for 10 years at an interest rate of 9% payable annually, then over that period you will make interest payments to your child that total \$900,000. If your preferred type of investment is fixed income, and you invest the loan proceeds and earns a 5% rate of return over the loan term (\$500,000), then your estate would be reduced by \$400,000 (\$900,000 - \$500,000). This money is in effect transferred to the child tax free.

If you die before the end of the loan term, you still achieve estate planning objectives. Although your taxable estate will include the loan proceeds, it should receive a deduction on its estate tax return for the present value of the remaining amount of the loan plus any accrued interest.

This technique will be useful in a situation where the rate of return on your investments exceeds the rate of return on your child's investments. This may depend in part on the types of investments and the level of sophistication of those investments. On the other hand, if you wish to build up your estate to take advantage of generation-skipping transfer tax planning, then this technique may be a possible solution.

Another situation where the market interest rate loan may be beneficial is if you have an investment portfolio composed mainly of assets with built-in capital gains. You may want additional capital to invest but would prefer to avoid capital gain recognition. An intrafamily loan can be made with less complication and lower closing costs than a commercial loan.

Consider Possible Consequences

The income tax consequences of a market interest rate loan are fairly straightforward. The lender must include the amount of interest payments received from the borrower in ordinary taxable income. The borrower may be able to deduct the interest payments depending on how the funds are invested. Whether

the interest payments will be deductible should be factored into the decision to proceed with this type of transaction.

The estate tax consequences of an interest-bearing loan should be favorable as long as you meet certain formalities. For example:

- The terms of the loan should be contained in a valid and enforceable promissory note.
- There should be a fixed maturity date.
- Any records maintained by the parties should reflect the transaction as a loan.

Moving Forward

When structured properly, this type of transaction should be without transfer tax consequences. Interest-bearing loans between family members are a simple yet effective method to transfer wealth to children or wealth to a parent. Our professionals can help with any related questions or concerns you may have.