Intra-Family Lending – Act Now!

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One of the best kept estate planning secrets is the "intra-family loan", an arrangement where one family member lends money to another family member at an interest rate that is much lower than the prevailing market interest rates. The intra-family loan is one of the easiest and most effective estate planning tools out there, especially in this low interest rate environment. It is simple to implement and the annual or monthly management is no more complicated than your average mortgage payment.

The estate planning benefits are very straight forward. If mom lends her son Charlie $1,000,000 for a period of three years, Charlie is free to invest those funds in any way that he chooses, and must return those funds to his mother at the end of the three years, with interest. If Charlie invests those funds and earns more money than he has to repay to his mother in interest, Charlie can walk away with a nice profit. For example, if mom lent Charlie that $1,000,000 for a single year on January 1, 2013 and Charlie invested the funds in the S&P 500 Index for all of 2013, Charlie would have earned 29.6% on his investment, or $296,000. Based on the minimum interest rate of 0.21% that mom had to charge for a loan in January of 2013 (see below for an explanation), Charlie would have repaid his mother $1,002,100, leaving him with a profit of almost $294,000. From an estate planning perspective, this works beautifully because all of that profit (i.e., the arbitrage above the applicable interest rate) passes to Charlie without any gift or estate tax, as long as the stated interest rate on the loan is greater than or equal to the Applicable Federal Rate (or "AFR").

The AFR is a set of interest rates that is published monthly based on outstanding marketable obligations of the United States. There are short-term, mid-term and long-term rates which are determined based on the preceding two months' average market yield on marketable Treasury bonds with corresponding maturity. The short-term rate applies to loans that are less than three years in duration. The mid-term rate applies to loans that are more than three years but less than nine years in duration. The long-term rate applies to loans that are more than nine years in duration.

The following table illustrates the AFRs for March 2015:

AFR RATE TABLE	Compounding Period			
	Annual	Semi-annual	Quarterly	Monthly
Short-term	0.40%	0.40%	0.40%	0.40%
Mid-term	1.47%	1.46%	1.46%	1.46%
Long-term	2.19%	2.18%	2.17%	2.17%

Current Long-Term Rate is Historically Low. While it is not news to most people that the overall interest rate environment that we are experiencing is extraordinarily low, I think it has been taken for granted over the past several years. Most of the intellectual capital in the estate planning universe has been spent on issues like portability and the federal estate tax exemption. While the short-term and mid-term rates have been slightly lower than they are for March of 2015, the long-term rate for March is at an all-time low (with the exception of September 2012 when the long-term rate was 2.18%, a whopping 1/100th of a percent lower).

What is most interesting about the March rates, however, is the compression of the mid-term and long-term rates. The difference between the mid-term of 1.46% and the long-term rate of 2.19% is only 0.73%. This means that our clients have a lot more flexibility with intra-family lending. Instead of trying to squeeze into a mid-term loan and worrying what the interest rate might be in 9 years (when you might want to refinance the loan), the "cost" of creating a long-term loan is not much higher.

In addition to the basic example that I illustrated above which provided a short-term "gift" to Charlie, a long-term intra-family loan can be an amazing long-term estate-freeze technique. Imagine replicating the Charlie example for 30 years by using a grantor trust (where the grantor pays all the income tax associated with the investment from assets that are outside of the loaned portfolio), but this time assuming a more modest 7% annual return. In that case, over a 30-year period, assuming full compounding and reinvestment with no distributions, the total wealth transferred to Charlie without any gift or estate taxes would be over $4,500,000.

Similarly, for your ultra high net worth clients who wish to use life insurance as an asset class to diversify his/her portfolio, a loan arbitrage strategy can be a great way to cover the cost of the premium payments without making taxable gifts. For example, if your client already has a funded trust (preferably a generation-skipping transfer tax exempt trust that is a grantor trust for income tax purposes), the client could make a substantial loan to the trust and use the arbitrage between the long-term AFR rate and the actual investment return to pay the annual premium payments. Note that this strategy can also work if the client does not yet have a funded trust – simply make use of the client's available lifetime gift tax exemption amount and fund the trust before making the loan (as having an appropriate amount of "seed capital" will be critical to ensuring that the loan is respected as bona fide debt).

At Thomas Brady & Associates we recently illustrated this option for one of our ultra high net worth clients. Even making very conservative assumptions about rates of return on the investment (we used rates of 4% and 5%), this structure worked incredibly well. Of course, with life insurance, the premium payments will be different for every client based on their age and underwriting status.

Best Practices. The key to any solid estate planning technique is to make sure that you establish and follow-through with the relevant formalities of the arrangement. Always make sure that your promissory note reflects the appropriate AFR for the date the loan was made. Use "term loans", i.e., loans with a fixed termination date (instead of "demand loans", which are loans that must be repaid at the request of the holder). Like every arms-length loan transaction, it is best if the borrower actually has the ability to repay the loan. The debt should be collateralized or secured and the parties should maintain records and written evidence of demands for payments by the holder and actual payments made by the borrower. ***Finally, with respect to loans used to finance the purchase a home, be aware that in order for the interest payments to be deductible by the borrower, the debt must be secured by the qualified residence, the residence must be able to be foreclosed upon in the event of default and the security interest must be recorded or otherwise perfected under state law.*** Failure to follow some of these basic parameters may result in the imposition of gift or estate taxes or, in the case of the loan to purchase real estate, the loss of the mortgage interest deduction. Working with a qualified estate planning lawyer is always recommended.

Intra-family loans are simple. Most clients understand how loans work and the documentation is straight-forward. The tax treatment is relatively clear. The lender will have income to the extent of any interest payments that are due, but the payments stay within the family which helps to preserve the overall family wealth. The current low interest-rate environment means that clients can lock in these benefits for the long-term. It is an excellent strategy for those clients who don't want to permanently lose control over their principal, and it allows the transfer of wealth to happen more gradually (instead of all at once with a singular gift). Finally, for those clients who have already made full use of their lifetime gift exemption, an intra-family loan is a great way to transfer additional assets to their family members.