Important Considerations in Intra-Family Loans

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Intra-family loans can be an effective estate planning tool in a variety of circumstances. Practitioners need to be aware of both federal tax law requirements and state law requirements when structuring an intra-family loan.

INTRODUCTION

Intra-family loans are made in a variety of circumstances. They can be made when a less-affluent family member wishes to borrow funds from a more-affluent family member. Or, they can be made as a wealth transfer tool. Such loans can even be made from a trust or a family-owned entity such as a limited partnership or limited liability company. A very common usage of intra-family loans is in sales to intentionally defective grantor trusts.

Given the likelihood of using notes in a wealth transfer planning practice, valuation analysts and tax practitioners should be thoroughly aware of the federal tax requirements, as well as the state law requirements, for promissory notes.

INTERNAL REVENUE CODE SECTION 7872

Unlike a typical commercial loan in which the lender seeks to maximize interest income and protect against the risk of default, intra-family loans typically seek to maximize the benefit to the borrower and, generally, focus less on protections against the risk of default. However, federal tax law establishes a practical floor for how generous loan terms may be to a given borrower. Indeed, at one time there was a question as to whether an interest-free loan was a gift for federal tax purposes.\(^1\)

Since the adoption of Section 7872 of the Internal Revenue Code of 1986, as amended (the “Code”), however, there is no question that certain below-market loans will be treated as gifts of the forgone interest by the lender.\(^2\)

Section 7872 causes certain “below-market loans” to be treated as if the borrower paid interest and the lender transferred the interest to the borrower as a gift.\(^3\) Generally, practitioners seek to avoid the characterization of loans as such below-market loans.

Although a complete discussion of the reasons to avoid the application of Section 7872 is beyond the scope of this essay, several reasons to avoid the application of Section 7872 are as follows.

First, the nature of imputed transfers is that no money or property actually changes hands, so the taxpayer or the taxpayer’s return preparer may be unaware of the deemed transfer and fail to report it or fail to plan for it.

Second, the control of the transaction is taken away from the involved parties. For example, under Section 7872(a), the deemed transfers are treated as occurring on the last day of the calendar year.\(^4\) Short of paying off the loan or establishing a loan that is not subject to Section 7872, the lender and borrower do not have the option of avoiding the deemed transfers by having the borrower actually pay interest.

If the loan is not subject to Section 7872, the lender may still choose to forgive the interest or make a gift to facilitate its payment. However, such actions are at the option of the lender, not a deemed transaction imposed by the Code.

Additionally, deemed gifts to trusts can result in a panoply of problems. For example, do the deemed...
For most loans, generally, the loan must require sufficient interest to escape the reach of Section 7872. .

Loans characterized as demand loans must charge the applicable federal rate (AFR) to avoid being characterized as below-market loans. Generally, the lowest rate that may be charged on a demand loan to avoid characterization as a below-market loan is a floating rate equal to the short-term AFR in effect for the semiannual period (either January 1 through June 30 or July 1 through December 31).

If the demand loan commences other than in January or July, the interest rate that may be charged for the first period is either the short-term AFR (with semiannual compounding) for the month in which the loan is commenced or the first month of that semiannual period (i.e., January or July).

For example, if a mother makes a $75,000 demand loan to her daughter on May 1, 2014, the loan must require that interest accrue at a minimum of 0.25 percent for the period of May 1 through June 30, 2014, because the short-term AFR (with semiannual compounding) for May 2014 is 0.33 percent and the short-term AFR (with semiannual compounding) for January 2014 is 0.25 percent.

If this same loan continued to be outstanding after June 30, 2014, starting on July 1, 2014, the loan would need to accrue interest at a rate of at least 0.31 percent, which is the short-term AFR for July 2014 (with semiannual compounding).

If a fixed rate of interest is charged on a demand loan and that loan remains outstanding over numerous semiannual periods, the loan could be a below-market loan in some periods (when the rate charged is below the applicable AFR) and not in others (when the rate charged is equal to or exceeds the applicable AFR).

Thus, as a practical matter, if a fixed rate of interest is desired on a demand loan and it is further desired that the loan never constitute a below-market loan, the terms of the loan should provide that the rate at any given time is the higher of the stated fixed rate or the special rate for demand loans set forth in the regulations.

For example, if in January 2003 a father loaned $100,000 to his child, payable on demand, with interest accruing at 3 percent, compounded annually, the loan would not initially be a below-market loan. This is because the short-term AFR with semiannual compounding was 1.80 percent in January 2003, even though the short-term AFR with semiannual compounding in March, April, May and June of 2005 exceeded 3 percent.

Since the short-term AFR with semiannual compounding for January 2005 (i.e., the special rate for
demand loans for the semiannual period of January 1, 2005, through June 30, 2005) was 2.76 percent, the loan would not be a below-market loan during the period of March 1 through June 30, 2005.

However, beginning July 1, 2005, this loan that commenced in 2003 at 3 percent (annual compounding) would be characterized as a below-market loan under Section 7872 beginning on July 1, 2005. This is because the rate charged is below the short-term AFR with semiannual compounding for July 2005 (3.42 percent). It is important to note that even if the loan rate had been 3.42 percent, because the note in this example only requires annual compounding, the loan would be a below-market loan; a higher rate of 3.45 percent (the July 2005 short-term AFR with annual compounding) would be required to avoid below-market loan status.\textsuperscript{17}

One may choose a demand loan if short-term interest rates are well below the rates for longer-term loans and interest rates are not expected to climb rapidly over the anticipated actual term of the loan or if interest rates are expected to decline.

Because midterm and long-term AFRs are currently near historical lows, demand loans are currently less appealing than loans with a fixed term because of the risk that rates will rise and the ability to “lock in” a low rate by setting a fixed term. It is important to note that the long-term rate can be used for any term loan greater than nine years.\textsuperscript{18} Accordingly, a loan could be made for a 30-year term, for example, using the long-term AFR.\textsuperscript{19}

Below-market term loans are defined as loans in which the amount loaned exceeds the present value of all payments due under the loan.\textsuperscript{20} However, because the present value for purposes of this determination is calculated using a discount rate equal to the AFR,\textsuperscript{21} charging the AFR should generally avoid characterization of a loan as a below-market loan for purposes of Section 7872.\textsuperscript{22} Exhibit 1 shows the AFRs for July 2014.

**AFR versus Market Rate of Interest**

AFRs are calculated based upon “outstanding marketable obligations of the United States.”\textsuperscript{23} As such, AFRs are typically lower than rates of interest commercially available to borrowers, even those with excellent cred-

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### Exhibit 1

**Applicable Federal Rates for July 2014**

<table>
<thead>
<tr>
<th>Period of Compounding</th>
<th>Semi-Annual</th>
<th>Annual</th>
<th>Quarterly</th>
<th>Monthly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-Term</td>
<td>0.31%</td>
<td>0.31%</td>
<td>0.31%</td>
<td>0.31%</td>
</tr>
<tr>
<td>Mid-Term</td>
<td>1.82%</td>
<td>1.81%</td>
<td>1.81%</td>
<td>1.80%</td>
</tr>
<tr>
<td>Long-Term</td>
<td>3.06%</td>
<td>3.04%</td>
<td>3.03%</td>
<td>3.02%</td>
</tr>
</tbody>
</table>

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### Exhibit 2

**Wealth Transfer from the Estate**

<table>
<thead>
<tr>
<th>The Estate’s Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year</strong></td>
<td><strong>Lender’s Principal</strong></td>
</tr>
<tr>
<td>1</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>2</td>
<td>$5,250,000</td>
</tr>
<tr>
<td>3</td>
<td>$5,512,500</td>
</tr>
<tr>
<td>4</td>
<td>$5,788,125</td>
</tr>
<tr>
<td>5</td>
<td>$6,077,531</td>
</tr>
<tr>
<td>6</td>
<td>$6,381,408</td>
</tr>
<tr>
<td>7</td>
<td>$6,700,478</td>
</tr>
<tr>
<td>8</td>
<td>$7,035,502</td>
</tr>
<tr>
<td>9</td>
<td>$7,387,277</td>
</tr>
</tbody>
</table>

**Estate Tax Liability @ 40% Tax Rate** | $3,102,656

**Net Wealth Transfer** | $4,653,985
term? The excess of growth over the AFR would not be includible in the parent’s estate. Assuming the July 2014 midterm AFR (annual compounding) of 1.82 percent and a growth rate of 5 percent, both the transfer to the child and the estate tax savings can be substantial, as shown in Exhibit 3.

Thus, the parent would be able to transfer about $1.75 million to the child during life without incurring gift tax, assuming the loan is deemed to be a bona fide loan, which is discussed in more detail in Exhibit 4.

The parent would still be subject to estate tax on the growth on the interest payments over the loan term, as well as the return of the principal. But, by making the loan, the parent can reduce his estate tax bill attributable to these same assets from $3.1 million to approximately $2.4 million at the end of nine years, for a tax savings of about $700,000.

However, it is important to note that although Section 7872 is one means by which a loan could result in taxable gifts under federal transfer tax law, it is not the only means, as the legitimacy of the loan itself can be questioned.

**Bona Fide Loans**

One important question to consider when making an intra-family loan is whether the Service will treat the loan as a bona fide loan, as opposed to a gift, for estate and gift tax purposes. Transactions between family members are subject to special scrutiny, and the presumption is that transfers between family members are gifts as opposed to loans.24

A taxpayer may rebut that presumption by an affirmative showing that at the time of the transfer, the transferor had a real expectation of repayment and an intention to enforce the loan.25

The underlying premise is that the mere promise to pay a sum certain, if accompanied by an implied understanding that the promise will not be enforced, is not deemed to have value or represent adequate and full consideration in money or money’s worth for estate and gift tax purposes.26

Courts consider certain factors to determine whether a transfer was made with a real expectation of repayment and an intention to enforce the loan. These factors include whether:

1. there was a promissory note or other evidence of indebtedness,
2. interest was charged,
3. there was any security or collateral,
4. there was a fixed maturity date,
5. a demand for repayment was made,
6. any actual repayment was made,
7. the transferee had the ability to repay,
8. any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and
9. the manner in which the transaction was reported for federal tax purposes is consistent with a loan.

No one factor is determinative, as this is a facts-and-circumstances investigation.27

In the **Lockett** case, certain transactions were deemed loans and certain transactions were deemed gifts.28 The two transfers that the court treated as gifts did not involve written promissory notes; additionally, no interest or principal on the transfers was paid, and there was no information as to whether the transferor or transferee treated the transfers as loans.29

In contrast, of the two transactions in **Lockett**...
that the court found constituted loans, the first transaction involved a written promissory note on which interest was charged.\textsuperscript{30} Although the transferee did not make any payments thereon, the transferor made a demand for payment and treated the transaction as a loan.\textsuperscript{31}

The second transfer that the court found to be a bona fide loan also involved a written promissory note, although it did not require security, there was no maturity date, and it was unclear whether the transferee could repay the loan. However, again the transferor made a demand for payment and treated the transaction as a loan.\textsuperscript{32}

The key point for practitioners seems to be that it is important to document the loan in a written promissory note, and that the note should appear as arms-length as possible.

**STATE LAW REQUIREMENTS**

In addition to the federal requirements discussed previously, practitioners should also consider the effect of state law upon the enforceability and administration of promissory notes, including any execution requirements, usury laws, and intangible taxes.

<table>
<thead>
<tr>
<th>Year</th>
<th>Interest Balance</th>
<th>Growth Rate</th>
<th>Interest Earned On Interest</th>
<th>AFR Loan Interest Rate</th>
<th>Interest Payment</th>
<th>Cumulative Interest Balance</th>
<th>Loan Repayment</th>
<th>Cumulative Principal + Interest Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$0</td>
<td>5.0%</td>
<td>$0</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$91,000</td>
<td>$0</td>
<td>$91,000</td>
</tr>
<tr>
<td>2</td>
<td>$91,000</td>
<td>5.0%</td>
<td>$4,550</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$186,550</td>
<td>$0</td>
<td>$186,550</td>
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<tr>
<td>3</td>
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<td>5.0%</td>
<td>$9,328</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$286,878</td>
<td>$0</td>
<td>$286,878</td>
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<tr>
<td>4</td>
<td>$286,878</td>
<td>5.0%</td>
<td>$14,344</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$392,222</td>
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<td>$392,222</td>
</tr>
<tr>
<td>5</td>
<td>$392,221</td>
<td>5.0%</td>
<td>$19,611</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$502,832</td>
<td>$0</td>
<td>$502,832</td>
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<td>6</td>
<td>$502,832</td>
<td>5.0%</td>
<td>$25,142</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$618,974</td>
<td>$0</td>
<td>$618,974</td>
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<tr>
<td>7</td>
<td>$618,974</td>
<td>5.0%</td>
<td>$30,949</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$740,923</td>
<td>$0</td>
<td>$740,923</td>
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<tr>
<td>8</td>
<td>$740,923</td>
<td>5.0%</td>
<td>$37,046</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$868,969</td>
<td>$0</td>
<td>$868,969</td>
</tr>
<tr>
<td>9</td>
<td>$868,969</td>
<td>5.0%</td>
<td>$43,448</td>
<td>1.82%</td>
<td>$91,000</td>
<td>$1,003,417</td>
<td>$5,000,000</td>
<td>$6,003,417</td>
</tr>
</tbody>
</table>

Estate Tax Liability @ 40% Tax Rate $2,401,367
Net Wealth Transfer (After Payment of Estate Tax) $3,602,050
Plus: Net Wealth Transfer From a Bona Fide Loan $1,753,224
Total Wealth Transfer $5,355,274

With regard to execution requirements for a promissory note to be enforceable, practitioners should determine who must sign and how. One issue that may arise is whether electronic signatures are effective and enforceable. If a loan document is prepared by the lender’s counsel, but the borrower is located across the country, the borrower may want to return the note by fax or e-mail.

A promissory note with such a signature may not be valid. For example, electronic signatures on New York promissory notes are likely not enforceable unless the electronic signature is made in such a way that only one executed note is created.\textsuperscript{33}

Practitioners should also be aware of usury laws. In these days of low AFRs, most intra-family loans would not likely exceed the rates of interest deemed to be usurious under state law.\textsuperscript{34}

However, practitioners should be aware of what their states’ usury laws provide. One situation that may implicate usury laws is if a default rate and/or other penalties are stacked upon the stated interest rate such that the total amount is over a state’s usury limit.

Finally, practitioners should check to see whether the execution of a promissory note in a particular
state results in an intangible tax. For example, Florida imposes a documentary stamp tax of 35 cents per $100 or fraction thereof of any indebtedness evidenced by any promissory note “made, executed, delivered, sold, transferred, or assigned in the state, and for each renewal of the same.”

The Florida documentary stamp tax is capped at $2,450, but the principal of the loan must be $700,000 before that cap applies. It is unclear in Florida whether a promissory note can be enforced when the documentary stamp was required but not paid.

**Use of Loans in Conjunction with Other Vehicles**

As discussed above, a loan from a parent to a child or grandchild can achieve meaningful wealth transfer. Loans can also be used to amplify or rescue other wealth transfer planning vehicles. For example, loans may be made to trusts. Loans are frequently made in connection with sales to intentionally defective grantor trusts; however, the availability of loans should not be overlooked even when no sale is involved.

Loans may be made to trusts to fund insurance premiums. This technique can prove useful when the grantor lacks sufficient GST exemption to fully cover gratuitous transfers to the trust. Because a bona fide loan that is not a below-market loan is not a transfer subject to the gift tax, the GST tax is not implicated and the inclusion ratio of the trust will not be impacted by a loan.

If the grantor lacks the funds or lacks the desire to fund a trust holding insurance on the grantor’s life, gifts by the beneficiaries are likely not an option for various reasons including, but not limited to the introduction of additional transferors for GST tax purposes and possible estate tax inclusion of the trust, or a portion thereof, in the estates of the new donor-beneficiaries. However, the beneficiaries of the trust can make loans to the trust without such problems.

As such, loans can “rescue” an irrevocable life insurance trust that may otherwise be short of funds. Of course, loans could be made to trusts to purchase assets other than insurance and the same rate arbitrage that occurs between individuals can be achieved between a lender and a trust.

However, the possibility for decline in assets should be considered. This is because, if the loan is a bona fide loan, the loan must be paid back even if the assets in the trust decline in value or fail to outperform the AFR. For this reason, loans to trusts even with insurance may not be a good long-term solution as the interest payments or accrual may deplete the value of the trust.

On the other hand, the leverage that can be afforded by loans to a child or to a trust can amplify the impact of a strategy. If the more senior generation can loan funds to a trust for the purchase of an asset anticipated to increase substantially in value, then the growth inside the trust can be increased. Increased leverage generally produces greater risk. However, the low rates currently available may lead many taxpayers to conclude the possibility that the assets will outperform the AFR warrants the increased risk.

**Alternatives to Intra-Family Loans**

Of course, intra-family loans are not the only way to transfer wealth. Practitioners should also consider whether alternative techniques, such as the use of grantor retained annuity trusts, qualified personal residence trusts, sales to intentionally defective grantor trusts, outright gifts, or other vehicles may better fit the estate planning needs of their clients.
or whether such alternatives should be used in connection with loans.

Each technique has its own advantages and disadvantages. Therefore, practitioners should take the time to thoroughly explore all avenues available to a client before embarking upon one or more of these transactions.

**Conclusion**

While intra-family loans are useful in many circumstances, practitioners should be aware of the myriad of issues that can arise.

Any drafter of a promissory note should be thoroughly familiar with the federal tax requirements, as well as the state laws governing promissory notes.

**Notes:**


2. See I.R.C. § 7872.


6. Id.


8. See I.R.C. § 7872(f)(5), (f)(6) (defining the terms “demand loan” and “term loan”); I.R.C. § 7872(e)(1) (defining below-market loans based upon the present value of all payments required, in the case of a term loan and upon the rate of interest charged, in the case of demand loans).


13. See Prop. Reg. § 1.7872-3(b)(3); see also Prop. Reg. § 1.7872-3(c)(3) ex. (5)(i).

14. The current short-term AFRs appear to be the same regardless of the period of compounding; the rates for July 2014 are 0.31 percent for annual, semiannual, quarterly, and monthly compounding. However, the rate for different compounding periods is “identical” due to low interest rates generally and because the AFRs are rounded to the nearest one-hundredth percent. The differences between compounding periods could be seen if the rates were rounded to a more precise rate, but since the AFRs are rounded, the differences are not apparent. Indeed, the rate differences between compounding periods can be seen in the current midterm AFRs, which for July 2014 are 1.82 percent for annual compounding, 1.81 percent for semiannual and quarterly compounding, and 1.80 percent for monthly compounding. Thus, practitioners should be sure to use the rate applicable for the period of compounding in order to avoid characterization of a loan as a below-market loan. An example in the proposed regulations highlights this issue; it states that a loan with annual interest payments that charges the rate based upon semiannual compounding will be characterized as a below-market loan “because, although interest is stated at a rate of 10 percent, a rate that reflects semiannual compounding is not appropriate for a loan with annual payments.” Prop. Reg. § 1.7872-3(c)(3) ex. (2). The more frequently interest is compounded, the lower the rate needs to be to meet with the definition of a below market term loan set forth in Section 7872(e)(1)(B), which defines below-market term loans in relation to the present value of all payments due under the loan. Of course, since the definition of a demand loan is based upon charging the AFR itself, since the AFR for demand loans in the proposed regulations is based on a semiannual period, a rate based on more frequent compounding (which, when rates are higher can be nominally lower than that for a semiannual period), if lower, would cause a demand loan to be characterized as a below-market loan for purposes of Section 7872.

15. The proposed regulations produce this result by treating the loan as a new loan in each semiannual period for the purpose of determining the AFR for that loan. See Prop. Reg. § 1.7872-3(c)(2).


17. See Prop. Reg. § 1.7872-3(c)(3) ex. 2 and ex. 5(ii).


19. Although there is no cap on how long a loan term can be, there may be some loan duration sufficiently long that it might be argued that the rate for demand loans should have been charged because the loan had an “indefinite” duration, see I.R.C. § 7872(f)(5), or that the loan was not a bona fide loan because of the length of the loan term, so care should be exercised in setting the loan term. It is common for a commercial mortgage loan to be for a fixed thirty-year term, so it seems that an intra-family loan could be structured similarly and both be recognized as a bona fide loan and as one with a fixed term.


However, if accrued interest is rounded to the nearest penny, on very large loans with accrual of interest, it may be possible to have a loan characterized as a below-market loan under this definition even though accrual of interest is calculated at the AFR. For example, if the terms of a loan provided that one hundred million dollars will be loaned from a father to his son on January 1, 2013 with the agreement that the son will repay the father, on December 31, 2023, a sum equal to $125,655,310.20 (the result of accruing interest annually at a rate of 2.31 percent, rounding to the nearest penny), the loan would technically be a below-market loan even though the AFR for January 2013 (2.31 percent with annual compounding) was used to calculate the final payment. If the son were required, instead, to pay $125,655,310.21 to the father on December 31, 2023, the loan would not be a below-market loan under the technical definition under Section 7872(e)(1)(B). Note the significant difference $0.01 would make however. If the loan is not a below-market loan, Section 7872 is inapplicable. If this loan were characterized as a below-market loan, Section 7872 would treat the forgiven interest as being transferred from lender to the borrower and retransferred by the borrower to the lender as interest. See I.R.C. § 7872(a) (1). In this case, the father would be deemed to have made a gift to the son in the amount of $2,31 million (the amount of forgiven interest under Section 7872(a)) in the first year alone. While this is an extreme example, it illustrates the importance of charging sufficient interest to avoid the application of Section 7872.

Thus, while many instruments may be executed by electronic signatures executed via many different means, a promissory note may require special execution requirements if an electronic signature is used.

For example, under Georgia law, the interest rate cannot exceed 16 percent on a loan with a principal amount of $3,000 or less, and any rate of interest may be charged on a principal amount involving $250,000 or more if established in a written contract. See O.C.G.A. § 7-4-2 (2014); see also O.C.G.A. § 7-4-6. However, charging more than 5 percent per month is a criminal offense under Georgia law. See O.C.G.A. § 7-4-18.

36. Id.
37. See, e.g., Glenn Wright Homes (Delray) LLC v. Lowry, 18 So.3d 693 (Fla. 4th DCA 2009) (retreating from prior cases in holding that § 201.08(1), Fla. Stat., “does not prohibit enforcement of an unsecured promissory note in a court of this state for nonpayment of the documentary stamp tax” and noting the conflict among different Florida District Courts of Appeal.).
38. It is important to note that a promissory note or other debt instrument may not be used to satisfy the annuity payment obligation in a grantor retained annuity trust. See Treas. Reg. § 25.2702-3(c)(4).
40. Of course, the loans should be bona fide loans. In addition, practitioners should exercise care to ensure that the fiduciaries are effectively discharging their fiduciary duties in borrowing from beneficiaries. This may require exploring other options such as reducing death benefit or inquiring about financing from commercial lenders.

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