

**IF YOU WILL<sup>®</sup>**: *Short Takes on Estates, Taxes and Trusts*

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*"IF YOU WILL<sup>®</sup>: Short Takes on Estates, Taxes and Trusts" is a quarterly glance through an informal lens at selected news items, court decisions, legislative changes and/or important issues pertinent to estate planning. It is primarily intended to inform and entertain you. But if it causes you to pick up the phone and call us with a legal question, we won't complain; and if it inspires you to examine our more in-depth legal updates, you can view them in the "Publications" section of our website at [burnslev.com](http://burnslev.com).*

**NOW IS THE TIME TO CONSIDER INTRA-FAMILY LOANS**

This is an excellent time for wealthy, senior family members to consider the use of loans to other family members as legitimate wealth transfer tools and for other planning purposes. Minimum required interest rates on loans, as set by Internal Revenue Service (IRS) regulations, are now very low, and the federal tax rate applicable to taxable transfers has increased by five percent as of January 1, 2013.

This edition of "If You Will" provides a brief overview of a few ways in which intra-family loans can be employed, and outlines some of the associated benefits.

**Loans from One Family Member to Another**

Senior family members often lend or give money to their children or grandchildren to buy a home, start a business or get an advanced degree of education. In some cases a loan can be better than a gift. For example, if parents lend a child funds to purchase a home that is purchased with the child's spouse, followed by the child's divorce, the in-law spouse may get less than if the funds were a gift. Or perhaps it is important to provide funds equally to all children, but family dynamics indicate that funds for some be provided as a loan rather than a gift.

In addition parents may not realize that such loans, if properly executed and documented, can be powerful wealth transfer tools for reducing tax exposure. This is particularly true in today's low interest rate environment, when IRS regulations pertinent to minimum allowable interest rates on legitimate notes and term loans are very favorable.

Required rates will vary depending upon the length of the loan and the rates set monthly by the IRS, but in the current environment they are well below the possible rates of return on the borrowed funds. Thus, a 10-year note can allow a young family borrower to obtain capital for just a few percentage points with an affordable, long-term monthly repayment schedule. Such loans can enable a family borrower to purchase a home, start a business or make another investment that could provide a significant annual rate of return well in excess of the interest rate. The spread between the interest rate and the actual rate of return is in effect a gift by the lender. With a large loan, this gift can amount to many thousands of dollars. Shorter loans at lower rates may be extended if a continued low interest rate justifies that at the time of the extension.

An intra-family loan can confer other benefits as well. When properly documented, it will not constitute a gift, and thus will not trigger gift tax or the use of lifetime exemption. It will also freeze the value of the loaned assets with regard to the lender's taxable estate, since once the loan occurs, the lender's estate will include only the balance of the note and payments received, not the appreciation that may occur afterward on the loaned assets.

Furthermore, if the money is used by the young borrower to invest in real estate or certain business assets, the limited interest he or she pays may be tax deductible.

If the debt cannot be repaid in full or on time, the lender may also forgive or refinance all or part of the debt. Depending upon the circumstances of the loan, this may trigger income tax consequences for the borrower or gift tax consequences for the lender, but the timing of the refinancing or forgiveness can sometimes be managed for optimal results.

Finally, there is no generation-skipping transfer tax applicable to loans made to grandchildren or other later generation borrowers, whereas a tax, or at least the use of available exemption, would apply to gifts made to those individuals.

The rules applicable to an intra-family loan require that the agreement be in writing, set at least the applicable IRS interest rate and contain a fixed schedule for repayment. The lender and borrower should also keep accurate records of all principal and interest payments in case the loan is ever questioned by the IRS.

## Loans from Trusts

Loans from trusts may be extremely useful. Suppose a deceased father established a trust for his descendants in which an independent trustee had discretion to distribute income and principal among his children, and expressed a wish — but not a directive — to make equal distributions to his children. Now one of the children needs funds to purchase a house. The trustee could provide the funds on an interest-free demand mortgage loan basis and reduce the borrower's income distributions by the income that would have been earned by the loan. If the house is sold, the funds will come back to the trust. If the trust terminates, the borrower's share of termination proceeds will include the loan. The other beneficiaries are not adversely affected and may at some point wish to obtain a similar loan. No interest is required for this sort of loan, and neither the borrower nor the lender has income or an available deduction.

## Takeaway

An intra-family loan can be a powerful tool in wealth transfer planning, but it is best crafted, honed and utilized with the help of a trained professional. The rules are intricate and all the facts and risks must be carefully considered. Please contact one of our estate planning attorneys if you have questions about using this tool for your benefit.

## Who Needs Estate Planning and When?

For many people, the value of an estate plan will far exceed its cost due to tax savings. Furthermore, estate planning is not just for individuals who have a net worth in excess of state or federal exemptions (currently set at \$1 million and \$5 million respectively, but subject to change). The following people can greatly benefit from estate planning with experienced legal counsel:

- Individuals or couples who have dependents or beneficiaries with special needs;
- Adoptive parents who need to make special provisions for inheritance that differ from state law provisions that apply to those without a legally enforceable plan;
- Other non-traditional families, such as those of unmarried couples or domestic partners;
- Married persons who have previous spouses or children from a prior marriage;
- Those who have special charitable goals; and
- Those who have ownership shares in a closely held business that could suffer grave disruption from an inheritance battle or significant death taxes on their estates (such people can benefit from a well-structured agreement providing for life insurance on key owners in amounts adequate to fund the purchase of a decedent's shares, according to valuations set in advance by agreement).

*NOTE: This newsletter is not intended to constitute legal advice, which always must be given based on the facts of a particular case. If you have any questions, do not hesitate to call us for additional information.*

For more information, please contact your Burns & Levinson attorney.

To learn more about our Trusts & Estates practice, visit [www.burnslev.com/our-practices/trusts-estates](http://www.burnslev.com/our-practices/trusts-estates).