Wealth Planning Insight

Silver Lining Playbook: Wealth Planning with Low Rates: Intra-Family Loans

Alison Kelly Hutchinson
Managing Director
Senior Wealth Planner

Family members regularly transfer assets between one another. Transfers between spouses are so common that the IRS completely disregards them for transfer tax purposes. Most frequent are transfers between parent and child and grandparent and grandchild. Over the past few weeks, many have lost jobs and are feeling financially insecure, and clients have asked us how they can help. If a parent transfers assets to a child and expects nothing in return, it is a gift, subject to gift tax or use of exemption. If a parent does not want to make a gift to her child, she can loan

assets to the same child, and the transfer will not be subject to gift tax or use of exemption. Making gifts or loans to family during times of financial turmoil is something that you may wish to do regardless of tax consequences or interest rates, but in a low interest rate environment such as the one we find ourselves in today, loans are particularly attractive from a tax perspective. Taking the time to properly document a transfer of assets as either a gift or a loan may save the entire family tax and stress down the road.

For a transfer to be respected as a loan rather than a gift, there must be an interest rate and an expectation of repayment. The IRS recognizes, however, that family members are willing to make loans to each other at lower interest rates than are standard for commercial transactions. These rates for "intra-family" loans are set by the IRS each month and change with other, more commercial interest rates. If a parent loans money to a child and charges no interest or interest at less than the IRS rate for that month, the "loan" can be recharacterized as a gift (subject to gift tax or use of exemption). If instead the parent engages her estate planning attorney to draft a simple loan document charging the applicable federal rate for the month the loan is made, there will be no gift, gift tax or use of exemption.

DATE	SHORT-TERM LOAN <3 YEARS>	MID-TERM LOAN 3-9 YEARS	LONG-TERM LOAN > 9 YEARS	HURDLE RATE* (GRATS)
April 2020	0.91%	0.99%	1.44%	1.2%
March 2020	1.50%	1.53%	1.93%	1.8%
March 2014	0.28%	1.84%	3.36%	2.2%
January 2013	0.21%	0.87%	2.31%	1.0%
March 2008	2.25%	2.97%	4.27%	3.6%
March 2002	2.69%	4.52%	5.48%	5.4%

For illustrative purposes; loan rates assume annual compounding.

**If the assets in a GRAT appreciate at a rate greater than the Hurdle, which the IRS sets each month, descendants receive assets transfer tax free.*

Interest rates for this type of loan are low and projected to move lower. To put these "low" rates in context, below is a chart showing some historical rates for loans between family members and how they stack up against current rates.

We have included the hurdle rates for the same time periods, to the extent you are also contemplating Grantor Retained Annuity Trusts (find them here).

	ASSUMED RATES OF RETURN		
	0.87%	3%	7%
Additional amount in child's account (or trust for child) after 8 years, as a result of this strategy	$0	$378,814	$1,257,852

For illustrative purposes.

These rates can be used to transfer assets from one family member to another transfer-tax free. For example, consider a client who took advantage of the low rates in January, 2013. He loaned his daughter $2 million for eight years. The IRS considers this is a "mid-term" loan, so the child had to pay her parent 0.87% interest annually (see the highlighted portion of the previous chart). This is a loan, not a gift, so the daughter also must pay back the full $2 million after eight years. If the child invested the $2 million at BBH, in her own private business or purchased real estate, as long as her investment grows at a rate greater than 0.87% before she has to pay it back, she is permitted to keep the appreciation transfer-tax free. If, for example, the $2 million enjoyed a 7% rate of return, the parent/client would have passed over $1 million to the child after 8 years, transfer tax free (see the nearby chart).

If the parent was feeling generous, he might decide to forgive some of the interest each year using his annual exclusion (currently $15,000 per year). If he was feeling especially generous, he might set up a GRAT for the benefit of the child, and she might in turn use any GRAT winnings to pay down the loan.

Similarly, if you or members of your family have loans currently outstanding, and those loans were documented using some of the higher rates of 2002 or even 2014, refinancing the note in a low interest rate environment would be a relatively painless way of reducing your estate and passing assets transfer-tax free to the borrower. The lower rate would mean less interest would be required to be paid back before the end of the note's term. As long as there is some consideration for refinancing (i.e., it is not just a gift from the lender to the borrower, but there is some reason to refinance – a longer loan term, or perhaps a partial prepayment), this strategy should not result in a gift tax or use of an exemption.

In the best-case scenario, these transactions are between the lender and a trust that is "grantor" as to

him or her for income tax purposes. For example, rather than the parent in the example above loaning his daughter $2 million directly, he would make the loan to a "grantor trust" that is written so that the daughter is a beneficiary of the trust. In this structure, the same impact is achieved, and there should be no income tax implications for interest payments/forgiveness between the parent and the trust for the benefit of the daughter. Your estate planning attorney and BBH Wealth Planner can describe the nuances of this common strategy as well as grantor trusts in more detail.

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