
# ESTATE PLANNING — INTRA-FAMILY LOANS

For clients with the capacity and interest to transfer wealth to family members, intra-family loans may be a strategy to discuss and consider. If structured and maintained properly, these loans may benefit both parties to the loan. An intra-family loan can provide resources to children, or to their trust, for a specific use or investment. On the other hand, the lender can incorporate the technique as part of the estate plan to achieve their objectives. Also, the interest rates used are usually more attractive than what is available commercially.

## Mechanics of an Intra-Family Loan

An intra-family loan is a financing arrangement between family members. The loan provisions include a stated interest rate, a set term if desired, may be made to a person or to a trust, and should be documented by a loan agreement and an amortization schedule. In order to avoid the loan being treated as a taxable gift, the stated interest rate should be at least the applicable federal rate (AFR) published by the Internal Revenue Service. Generally, the AFR is lower than rates charged by a commercial lender, whether for a business loan or for a home mortgage. A loan can be repaid over time with regular principal payments, or with a balloon payment. Additionally, principal may be forgiven using annual exclusion gifts, or from a unified credit.

During the life of the loan, income tax and gift tax compliance matters need to be addressed. Interest paid to the lender must be recognized as income on the lender's income tax return. Depending upon the use of the loan proceeds, the interest paid may be deductible by the payor as a business expense, or as deductible interest on the borrower's individual tax or trust tax return. Also, depending upon what the loan proceeds are used for, securitization of the loan is suggested. The loan should be documented at a minimum with the following information:

- Signed promissory note / loan agreement
- Repayment schedule
- Interest rate at least equal to the AFR corresponding to the month the loan was made (for demand loans, alternate rules apply)
- Payment records
- If this is a mortgage loan, a Form 1098 should be issued for the annual interest expense
- Securitization records (if applicable)
- Any necessary changes to the estate plan of the lender

## Best Practices

In addition to the compliance and documentation requirements for family loans, the advisor can assist clients with family governance practices to support family lending.  For example, the advisor may suggest that the client establish guidelines on how to make a loan request. The lender can establish (1) information that must be provided, (2) who is eligible to request loans, (3) potential limitations on the use of the loan proceeds, and (4) fair, but not necessarily equal loans, among different family members. Proper titling of the loan agreement should be considered as well, regarding to which family trust or family member(s) are parties to the loan agreement.

Information should be shared with the tax advisors, at least annually, to ensure that appropriate information is reported on the parties' tax returns. The lender's income tax return should report the interest income, while the borrower's return should reflect the deduction, if any. Also, tax projections and the client's financial plan should be updated accordingly. If the lender decides to forgive interest and/or principal, amortization schedules should be updated as this occurs on the client's behalf.

Loan forgiveness has gift tax consequences as well. If annual exclusion amounts are to be considered in the forgiveness of interest and/or principal, the advisor should consider other uses of the annual exclusion, such as premium payments paid on behalf of a life insurance trust. Other gifts will reduce the amount of annual exclusion available to forgive a portion of the loan. If the annual exclusion is exceeded, the gift tax return must reflect a portion of the unified credit (if any) being used for the amount exceeding the annual exclusion.

The implementation of any wealth transfer strategy requires careful planning and coordination with a client's existing financial plan and among the client's advisors. Initial and ongoing communication and collaboration with the client and the tax advisors and estate attorneys is critical to the successful outcome of this lending.

## Intra-Family Loans

- Wealth transfer strategy that is fairly straight-forward to understand and implement
- Structure and maintenance of the loan is necessary to avoid unexpected taxable gifts
- Vehicle to provide financial resources to family members in a cost and tax effective way
- **Pros:**
  - Low-cost wealth transfer strategy.
  - Trusts can be (but do not have to be) used to provide additional control.
  - Interest rates are generally lower than commercially available rates.
  - Flexibility in loan structuring to achieve planning goals for both parties.
  - Wealth transfer without gift tax implications is possible, if the assets transferred are used to invest in assets that have a total return greater than the cost of the interest charged.
  - Interest paid stays within the family rather than paid to an outside financial institution.
  - Families may structure a family bank to encourage an environment of entrepreneurship and/or investing.
  - Family members can be helped during periods of financial stress or when starting a business.
  - Gifting/forgiving the loan can be done efficiently (and carefully) when/if desired.
  - Refinancing or prepaying the loans may be possible (if structured as such).
- **Cons:**
  - Recharacterization of a loan to be a taxable gift may occur.
  - Income and gift tax compliance matters need to be addressed over the life of the loan.
  - Changes to existing estate documents may be necessary to address what happens to the loan if outstanding at the lender's death, and/or to equalize other estate provisions reflective of this lending.
  - Family discord may erupt due to loans being made on an unequal basis, or if loans are not repaid timely.
  - Clients need to understand their capacity to transfer assets before committing to this strategy.

Learn more about how Choreo's wealth management solutions can help your firm and your clients.
www.choreoadvisors.com

Choreo, LLC is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Registration as an investment adviser does not imply a certain level of skill or training of the adviser or its representatives. This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, insurance, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. Information has been obtained from a variety of sources believed to be reliable though not independently verified. Choreo, LLC its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed. The sole purpose of this document is to inform, and it is not intended to be an offer or solicitation to purchase or sell any security, or investment or service. Investments mentioned in this document may not be suitable for investors. Before making any investment, each investor should carefully consider the risks associated with the investment and make a determination based on the investor's own particular circumstances, that the investment is consistent with the investor's investment objectives.

© 2023 Choreo, LLC. All Rights Reserved.