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INSTITUTE FOR CONTINUING LEGAL EDUCATION

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ESTATE PLANNING AND ADMINISTRATION USING INTRA FAMILY LOANS

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Presented by:

Bruce E. Mantell, C.P.A., Esq., LL.M.

MANTELL, PRINCE & REYNOLDS, P.C.
Mountain Heights Center at Berkeley Heights
430 Mountain Avenue, Suite 113
Murray Hill, New Jersey 07974
908-464-5900
FAX: 908-464-5901
e-mail: bmantell@mantell-prince.com
www.mantell-prince.com

ESTATE PLANNING AND ADMINISTRATION
USING INTRA-FAMILY LOANS

By: Bruce E. Mantell, Esq.

I. INTRA-FAMILY LOANS AND NOTES

A. Reason. The allure of intra-family loans is a function of the fact that the Applicable Federal Rate ("AFR") is generally lower than the prevailing market interest rate in commercial transactions. See Exhibit A for June, 2012 AFR.

B. Example. Possible uses of intra-family loans and notes include:

1. Loans to children with or without significant net worth;

2. Loans to grantor trusts;

3. Sales to children or grantor trusts for a note;

4. Loans between related trusts (e.g., from a bypass trust to a marital trust, from a marital trust to a GST exempt trust, such as transactions to freeze the growth of the marital trust and transfer appreciation to the tax-advantaged trust);

5. Loans to an estate;

6. Loans to trusts involving life insurance (including split dollar and financed premium plans--these are outside the scope of this outline);

7. Home mortgages for family members;

8. Loans as vehicles for gifts over time by forgiveness of payments in some years, including forgiveness of payments in 2012 as a method of utilizing $5,120,000 gift exemption available in 2012; and

9. Notes from client to family members at a higher interest rate (to afford higher investment returns to those family members than they might otherwise receive).

C. Advantages of Loans and Notes.

1. Arbitrage. If the asset that the family member acquires with the loan proceeds has combined income and appreciation above the interest rate that is paid on the note, there will be a wealth transfer without gift tax implications. With the current incredibly low interest rates, there is significant opportunity for wealth transfer.

2. <u>Keep in the Family.</u> Interest payments remain in the family rather than being paid to outside banks.

3. <u>Poor Credit History</u>. Intra-family loans may be the only source of needed liquidity for family members with poor credit histories.

4. <u>Closing Costs</u>. Borrowing from outside lenders may entail substantial closing costs and other expenses that can be avoided, or at least minimized, with intra-family loans.

II. LOAN VS. GIFT

A. <u>Gift Presumption</u>. A transfer of property in an intra-family situation will be presumed to be a gift unless the transferor can prove the receipt of "an adequate and full consideration in money or money's worth."

B. <u>Bona Fide Loan Requirement</u>. In the context of a transfer in return for a promissory note, the gift presumption can be overcome by an affirmative showing of a bona fide loan with a real expectation of repayment and an intention to enforce the debt. The court has applied seven factors in determining that there was not a bona fide loan: (1) existence of a note, (2) payment of reasonable interest, (3) fixed schedule of repayment of principal, (4) adequate security, (5) actual repayment, (6) reasonable expectation of repayment in light of the economic realities, and (7) conduct of the parties indicating a debtor-creditor relationship.

C. <u>Intent to Forgive Loan</u>.

1. <u>Prearranged Plan to Forgive Loan</u>. Revenue Ruling 77-299 announced the IRS position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.

2. <u>Possibility of Forgiveness of Loan</u>. Even if the lender actually intends to gradually forgive the entire loan, (1) he is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. Therefore, if the loan is documented and administered properly, this technique should work, even if there is a periodic forgiveness plan, since the intent to make a gift in the future is not the same as making a gift in the present. However, if the conduct of the parties negates the existence of an actual bona fide debtor-creditor relationship at all, the entire loan may be re-characterized as a gift at the time the loan was made or the property lent may be included in the lender's estate, depending on whether the lender or the borrower is

considered to really own the property.

3. Inability to Repay. If the borrower is insolvent (or otherwise clearly will not be able to pay the debt) when the loan is made, the lender may be treated as making a gift at the outset.

D. Points To Consider in Structuring Loan.

1. Formalities of Loan. Where the donor intends to forgive the note payments, it is especially important to structure the loan transaction to satisfy as many of the elements as possible discussed above in distinguishing debt from gift. In particular, there should be written loan documents, preferably the notes will be secured, and the borrower should have the ability to repay the notes. If palatable, do not forgive all payments, but have the borrowers make some of the annual payments.

2. Generally Use Term Loans Rather Than Demand Loans. For a demand loan, the stated interest rate is compared to the AFR throughout the loan, and gifts will result for any period during which the stated interest rate is less than the AFR for that period. For term loans, however, the stated interest rate is compared to the AFR at the time the loan is originated to determine if the loan results in a gift. In light of this treatment, using term loans has two distinct advantages. First, there is no complexity of repeatedly determining the appropriate AFR for any particular period. Second, during the current incredibly low interest rate environment, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

3. Lend to Borrowers With the Ability to Repay. One of the factors in determining whether the loan is a bona fide loan rather than an equity transfer is whether the borrower had the ability to repay. The borrower's ability to repay the loan is a very important factor in establishing that a bona fide debtor creditor relationship exists. This can be very important for income, gift and estate tax purposes. This includes loans to trusts; the trust should be funded with enough assets that it has the ability to repay the loan even if there is some decline in the value of the trust assets.

4. Forgiveness as Gift. Is the forgiveness of a large loan in the environment of a $5,120,000 lifetime exemption an effective gift?

   a. No Interest Payments. Borrower avoids having to pay interest to the lender. But in low interest environment the interest paid is not significant and often the lender makes gifts to borrower to repay the interest.

b. Claw Back. The claw back obviates the advantages of forgiving the loan as a gift because it is added back to the estate on Form 706. See Exhibit B.

E. Advantages of Gifts Over Loans. If a client inquires about making a loan to children, consider whether gifts would be more appropriate.

1. Circumstances Indicating a Gift is Preferable to a Loan. Several circumstances suggesting that a gift may be preferable include: (i) the lender does not need the funds to be returned; (ii) the lender does not need cash flow from the interest on the loan; (iii) it is not apparent how the loan will ever be repaid; and/or (iv) the lender does not plan on collecting the loan.

2. Note Receivable in Client's Estate. The Note Receivable will be included in the client's estate for estate tax purposes. In particular, make use of annual exclusion gifts, which allow asset transfers that are removed from the donor's estate and that do not use up any gift or estate exemption.

3. Lower Effective Gift Tax Rate If Live Three Years. The gift tax rate is applied to the net amount passing to the donee, whereas the estate tax rate is applied to the entire state, including the amount that will ultimately be paid in estate taxes. If the donor lives for three years, gift taxes paid are removed from the gross estate.

4. Fractionalization Discounts. If the client transfers a fractional interest or a minority interest in an asset owned by the client, the transfer may be valued with a fractionalization discount. On the other hand, if cash is loaned to the child, no fractionalization discounts are appropriate.

5. State Death Tax Avoidance. Gifts remove assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate).

6. Avoiding Interest Income. If the transfer is structured as a loan, the parent will recognize interest income (typically ordinary income) at least equal to the AFR, either as actual interest or as imputed interest, thus increasing the parent's income tax liability.

7. Avoiding Accounting Burden. Someone must keep track of the interest as it accrues to make sure that it is paid regularly or is reported as income. This can be particularly tedious for a demand loan or variable-rate term loan where the interest rate is changing periodically. There are additional complications for calculating the imputed interest for below-market loans

(which means that loans should always bear interest at least equal to the AFR).

8. Avoiding OID Computations If Interest Not Paid Annually. If interest is not paid annually, the original issue discount (OID) rules will probably require that a proportionate amount of the overall interest due on the note will have to be recognized each year by the seller, even if the seller is a cash basis taxpayer. Determining the precise amount of income that must be recognized each year can be complicated, particularly if some but not all interest payments are made. The OID complications can be avoided if the loan is made to a grantor trust.

9. Avoiding Non-Performance Complications. If the borrower does not make payments as they are due, additional complications arise:

   a. Possible Re-characterization as Gift. The IRS takes the position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.

   b. Imputed Gift and Interest Income. Even if the loan is not treated as a gift from the outset, forgiven interest may be treated the same as forgone interest in a below-market loan, resulting in an imputed gift to the borrower and imputed interest income to the lender.

   c. Modifications Resulting in Additional Loans. If the parties agree to a loan modification, such as adding unpaid interest to the principal of the loan, the modification itself is treated as a new loan, subject to the AFRs in effect when the loan is made, thus further compounding the complexity of record keeping and reporting.

   d. Loan to Grantor Trust Can Have Same Advantages of Gift. One of the advantages of making gifts to a grantor trust is that the grantor pays income taxes on the grantor trust income without being treated as making an additional gift. This allows the trust assets to grow faster (without having to pay taxes) and further reduces the grantor's estate for estate tax purposes. This same advantage is available if the loan is made to a grantor trust. In addition, making the loan to a grantor trust avoids having interest income taxed to the lender-grantor, and avoids having to deal with the complexity of the OID rules.

III. VALUATION OF NOTES

A. Discounting Notes in Subsequent Transactions. Under gift and estate tax regulations, the value of a note is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate, date of maturity, security, etc.) or is uncollectible in whole or in part. A wide variety of cases have valued notes at a discount from face value based on satisfactory evidence.

B. Gift Tax Purposes.

1. Differential in Interest Rates is Not Gift. For gift tax purposes, a loan is not deemed to be worth less than face value because of the interest rate as long as the interest rate is at least equal to the AFR.

2. Other Factors. However, other factors can be considered (for example, the ability of the borrower to repay) in determining the value of the note, and if the note is worth less than the amount transferred a gift results.

C. Estate Tax Purposes. For estate tax purposes, a note can be discounted because of interest rate changes or because of collectability problems (e.g., insolvency of the borrower or insufficiency of collateral). In addition, there may be the possibility of discounting a note merely because it uses the AFR interest rate, which is less than a commercially reasonable rate that would apply to such a loan. There is no statute or final regulation requiring that §7872 principles for valuing notes using the AFR also apply for estate tax proposes. However, the IRS fights that argument.

IV. REFINANCING NOTES TO UTILIZE LOWER INTEREST RATES

A. No Cases, Regulations or Rulings. There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under §7872 include a section entitled "Treatment of Renegotiations," but merely reserves the subject for later guidance, which has never been issued.

B. Analogy to Residential Refinancing. If the borrower can prepay the note without a penalty at any time, and if prevailing interest rates decline, the borrower would likely pay off the original note and borrow the amount on a new note at current rates. That happens daily with thousands of homeowners refinancing their mortgages as interest rates have declined. The borrower could either (i) pay off the original loan (with the higher interest rate) and borrow again at the lower rate, or (ii) give a new note (at the current AFR) in substitution for the original note (with the higher interest rate).

C. Repetitive Refinancing. A possible concern is that consistent refinancing of the note may be a factor in determining that the loan transaction does not result in bona fide debt, but should be treated as a gift transfer. In light of the lack of any case law or direct discussion of refinancings at lower AFRs in regulations or in any rulings, most planners suggest caution in this area, and not merely refinancing notes every time the AFR decreases.

D. Payoff of Portion of Principal as Consideration. Some advisors believe that consideration should be given for a lower rate by the estate paying down the principal amount, shortening the maturity date, or adding more attractive collateral.

E. Make certain the Note includes a Prepayment Clause. The ability to repay the Note and then borrow again at lower rate is a compelling argument that the refinancing is valid and does not have a gift element. If no Prepayment Clause exists in the Note, then the refinancing may have gift elements. See Exhibit C for a Promissory Note with a Prepayment Clause.

V. LOANS TO ESTATES DURING ESTATE ADMINISTRATION

A. Liquidity Needs. Estates often have liquidity needs for a variety of reasons, not the least of which is to be able to pay federal and state estate taxes within eight to nine months after the date of death.

1. Loan From Family Members or Family Entities. Other family entities may have liquid assets that would permit loans to the estate. This is a very commonly occurring situation. A very important tax issue that arises is whether the estate will be entitled to an estate tax administrative expense deduction for the interest that it pays on the loan.

2. Loan to Beneficiaries. Of less importance are situations in which beneficiaries need advances, before the executor is in a position to be able to make distributions. One possible scenario where this can occur is if only one beneficiary needs assets from the estate quickly, but the executor wants to make pro rata distributions when distributions are made. An advance could be made to the one beneficiary with needs until distributions can be made.

B. Estate Tax Administrative Expense Deduction for Interest Payments.

1. Generally. I.R.C. Section 2053 does not refer to the deduction of interest as such. To be deductible, interest must qualify as an administration expense. Deducting interest as an estate tax deduction is not as attractive as it has been in the past because the interest would be recognized as income when received and the decrease in the estate tax rates reduces the

amount of arbitrage on the rate differential between the estate tax savings and the income tax cost. Even so, substantial savings may be achieved because the estate tax reduction occurs eight to nine months after date of death whereas the interest income may not be recognized until later years.

2. Post-Death Interest on Federal Estate Tax. Interest payable to the IRS on a federal estate tax deficiency is deductible as an administration expense to the extent the expense is allowable under local law. Unlike interest payable to the IRS on deferred estate tax payments, interest on private loans used to pay estate taxes is not automatically deductible. The IRS recognizes that interest is deductible on amounts borrowed to pay the federal estate tax where the borrowing is necessary in order to avoid a forced sale of assets. The interest is deductible only for the time period for which the loan is reasonably necessary for that purpose.

3. Timing of Interest Deduction For Interest on Extension to Pay Federal Estate Tax. When the estate receives an extension to pay estate tax under §6161, the interest is deductible only when it is actually paid. In Rev. Rul. 80-250, the IRS gave two reasons for refusing to allow an "up-front deduction" for the interest:

   a. An estate can accelerate payment of the deferred tax.

   b. The interest rate of the deferred amount fluctuates, which makes it impossible to accurately estimate the projected interest expense.

4. Estate of Graegin Approved Up-Front Deduction.

   a. Estate of Graegin v. Commissioner. The Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation.

   b. Interest Ascertainable. The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note.

   c. Reason for Borrowing Valid. Most of the cases involving Graegin loans have allowed the up-front interest deduction, in situations where the estate could establish a reason for the borrowing other than to generate the estate tax deduction, and courts are reluctant to second guess the business judgment of the executor.

   d. IRS Continues to Challenge. IRS officials have stated informally that the IRS is continuing to look for vehicles to contest Graegin loans, particularly in situations involving family limited partnerships. The IRS's concern is that a deduction will be allowed but the interest in fact will not have to be paid over the entire term of the note.

5. <u>Example of Favorable Results of Graegin Loan</u>.

a. The economics of the up-front Graegin deduction can be significant.

b. **<u>Example 1</u>. Assume a $10,000,000 taxable estate. Assume the marginal estate tax bracket is 45%. Assume the estate would owe $4,500,000 ($10,000,000 x 45%) in estate taxes. [Obviously, those numbers are not accurate and are being used only for illustrative purposes] Assume the estate borrows $4,500,000 from a closely-held company under a 15 year note, at 6.0% interest, with a balloon payment at the end of the 15 year period to pay the estate tax. The accumulated interest payment due at the end of the 15 years would be $4,050,000 ($4,500,000 x 6% x 15). Under the Graegin analysis, the interest expense would be currently deductible for estate tax purposes, yielding a taxable estate of $5,950,000 ($10,000,000 - $4,050,000), which would result in a federal estate tax of $2,677,500 ($5,950,000 x 45%). The $4,050,000 of interest would be paid to the company (which, in turn, is owned primarily by family members). The overall result is a very considerable estate tax savings of $1,822,500 ($4,500,000 - $2,677,500). In New Jersey there will also be significant NJ estate tax savings. The quid pro quo, of course, is that the interest income will be subject to income tax at the end of the 15-year period. However, many families are willing to pay income taxes in 15 years if they can reduce the estate taxes that are due nine months after the date of death.**

6. <u>New Regulation Project Considering Applying Present Value of Administration Expenses and Claims to Graegin Loans</u>. The I.R.C. Section 2053 final regulations do not seem to impact Graegin loans at all. However, the Treasury Priority Guidance Plans for 2009-2012 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

XHIBIT A

Applicable Federal Rates (AFR) for June 2012

		Period for Compounding		
	Annual	**Semiannual**	**Quarterly**	**Monthly**
Short-Term				
AFR	.23%	.23%	.23%	.23%
110% AFR	.25%	.25%	.25%	.25%
120% AFR	.28%	.28%	.28%	.28%
130% AFR	.30%	.30%	.30%	.30%
Mid-Term				
AFR	1.07%	1.07%	1.07%	1.07%
110% AFR	1.18%	1.18%	1.18%	1.18%
120% AFR	1.28%	1.28%	1.28%	1.28%
130% AFR	1.39%	1.39%	1.39%	1.39%
150% AFR	1.62%	1.61%	1.61%	1.60%
175% AFR	1.88%	1.87%	1.87%	1.86%
Long-Term				
AFR	2.64%	2.62%	2.61%	2.61%
110% AFR	2.90%	2.88%	2.87%	2.86%
120% AFR	3.16%	3.14%	3.13%	3.12%
130% AFR	3.44%	3.41%	3.40%	3.39%

EXHIBIT B

Form **706**

(Rev. August 2011)

Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2010, and before January 1, 2012.

OMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)	1b Decedent's last name			2 Decedent's social security no.
3a County, state, and ZIP code, or foreign country, of legal residence (domicile) at time of death	3b Year domicile established	4 Date of birth		5 Date of death
	6b Executor's address (number and street including apartment or suite no.; city, town, or post office; state; and ZIP code) and phone no.			
6a Name of executor (see instructions)				
6c Executor's social security number (see instructions)	Phone no.			
7a Name and location of court where will was probated or estate administered				7b Case number

8 If decedent died testate, check here ▶ ☐ and attach a certified copy of the will. 9 If you extended the time to file this Form 706, check here ▶ ☐

10 If Schedule R-1 is attached, check here ▶ ☐

Part 2—Tax Computation

1	Total gross estate less exclusion (from Part 5—Recapitulation, item 12)		1	
2	Tentative total allowable deductions (from Part 5—Recapitulation, item 22)		2	
3a	Tentative taxable estate (before state death tax deduction) (subtract line 2 from line 1)		3a	
b	State death tax deduction		3b	
c	Taxable estate (subtract line 3b from line 3a)		3c	
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))		4	
5	Add lines 3c and 4		5	
6	Tentative tax on the amount on line 5 from Table A in the instructions		6	
7	Total gift tax paid or payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)		7	
8	Gross estate tax (subtract line 7 from line 6)		8	
9	Maximum unified credit (applicable credit amount) against estate tax (see instructions)	9		
10	Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed $6,000. See instructions.)	10		
11	Allowable unified credit (applicable credit amount) (subtract line 10 from line 9)		11	
12	Subtract line 11 from line 8 (but do not enter less than zero)		12	
13	Credit for foreign death taxes (from Schedule P). (Attach Form(s) 706-CE.)	13		
14	Credit for tax on prior transfers (from Schedule Q)	14		
15	Total credits (add lines 13 and 14)		15	
16	Net estate tax (subtract line 15 from line 12)		16	
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)		17	
18	Total transfer taxes (add lines 16 and 17)		18	
19	Prior payments. Explain in an attached statement		19	
20	Balance due (or overpayment) (subtract line 19 from line 18)		20	

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

EXHIBIT C

PROMISSORY NOTE

Principal Amount:
Interest Rate:
Annual Amount:

Date of Note:
Maturity Date:

Name and Address of Maker:

____
____
____

Name and Address of Payee:

____
____
____

PROMISE TO PAY: In exchange for value received by the Maker, the Maker agrees to pay to the order of the Payee the Principal Amount, plus interest, in accordance with the terms of this Note.

INTEREST: Interest will accumulate at the Interest Rate on the portion of the Principal Amount that is outstanding from time to time from the Date of Note until the Note is paid in full.

PAYMENTS: The Annual Amount shall be paid on _________ of each year for Nine (9) years, commencing on _____________, and continuing until and through the Maturity Date. On the Maturity Date, in addition to the last Annual Amount, the remaining Principal Amount that is outstanding shall be paid in full, such payments to be based upon a Thirty (30) year amortization schedule, a copy of which is attached hereto. All payments are to be made at the address of the Payee, or at any other address designated by the holder of this Note to the Maker in writing.

PREPAYMENT: The Maker may pay this Note, in whole or in part, at any time before it becomes due, without penalty.

DEFAULT: The entire outstanding Principal Amount, together with all accumulated interest, will (at the option of the holder of this Note) become due immediately if any of the following events occurs: (a) any amount due under this Note is not paid within 30 days after its due date; or (b) any bankruptcy or insolvency proceeding relating to the Maker (whether voluntary or involuntary) is begun; or (c) the Maker becomes insolvent or makes an assignment for the benefit of creditors; or (d) a receiver, trustee or other similar official is appointed for the Maker or for substantially all of the Maker's property.

CERTAIN FORMALITIES: In enforcing this Note, the holder of the Note will not be required to do any of the following: (a) demand payment of the amount due (known as "presentment"); (b) give notice that amounts due have not been paid (known as "notice of dishonor"); or (c) obtain an official certification of nonpayment (known as "protest").

COLLECTION COSTS: The Maker agrees to pay all costs (including attorneys' fees) that are reasonably incurred by the holder of this Note in collecting the Note following a default.

CHANGES AND WAIVERS: None of the provisions of this Note may be changed or waived, except by a written instrument signed by the holder of this Note.

LAW: This Note will be enforced in accordance with the laws of the State of New Jersey.

COPY RECEIVED: The Maker acknowledges receipt of a completely filled-in copy of this Note.

AGREEMENT: The Maker agrees to the terms of this Note by signing below.

WITNESS:	MAKER:
_________________________	_________________________