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Estate Planning Issues With Intra-Family Loans and Notes

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1. Examples of Uses of Intra-Family Loans and Notes

Many of the uses of intra-family loans take advantage of the fact that the applicable federal rate ("AFR") is generally lower than the prevailing market interest rate in commercial transactions. Examples of possible uses of intra-family loans and notes include:

1. Loans to children with significant net worth;
2. Loans to children without significant net worth;
3. Non-recourse loans to children or to trusts
4. Loans to grantor trust;
5. Sales to children or grantor trust for a note;
6. 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);
7. Loans to an estate;
8. Loans to trusts involving life insurance (including split dollar and financed premium plans);
9. Home mortgages for family members;
10. Loans for consumption rather than for acquiring investment assets (these may be inefficient from an income tax perspective because the interest payments will be personal interest that does not qualify for an interest deduction);
11. 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 the $5.0 million gift exemption available in 2012;
12. Loans from young family members to the client for a note at a relatively high interest rate (to afford higher investment returns to those family members than they might otherwise receive); (in a different context, the Tax Court in *Estate of Duncan* acknowledged the reasonableness of paying an interest rate higher than the AFR); and
13. Client borrowing from a trust to which the client had made a gift in case the client later needs liquidity (and the resulting note amount may be deductible as a bona fide debt at the client's death if the note is still outstanding at that time).

2. Advantages of Loans and Notes

a. *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 incredibly current low interest rates, there is significant opportunity for wealth transfer.

b. *"All in the Family."* Interest payments remain in the family rather than being paid to outside banks.

c. *Poor Credit History*. Intra-family loans may be the only source of needed liquidity for family member members with poor credit histories.

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

3. Advantages of Gifts Over Loans

a. *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) how the loan will ever be repaid is not apparent; and/or (iv) the lender does not plan on collecting the loan.

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

c. *Traditional Gift Advantages*. Traditional gift advantages include (1) taking advantage of the lower effective gift tax rate if the donor lives at least three years, (2) using fractionalization discounts, and (3) state death tax avoidance.

d. *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.

e. *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).

f. *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 lender, even if the lender 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.

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

Possible Recharacterization as Gift. As discussed in the next Item, the IRS takes the position that if the "lender" intended to forgive the note from the outset, the transfer is a gift. While some cases have rejected this approach, and while the lender can attempt to establish that there was no intention from the outset of forgiving the loan, if the lender ends up forgiving some or all of the note payments, questions can arise, possibly giving rise to past due gift tax liability which could include interest and penalties.

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. (However, if the forgiveness includes principal "in substantial part" as well as interest, it may be possible for the lender to avoid having to recognize accrued interest as taxable income.)

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.

4. Upfront Gift If Intent to Forgive Loan?

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 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. However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the door will have made a gift only at the time of the forgiveness. The IRS relied on the reasoning of *Deal v. Commissioner*.

The Tax Court had reached a contrary result in several cases that were decided before the issuance of Rev. Rul. 77-299 (and the IRS non-acquiesced to those cases in Rev. Rul. 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance. The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable. *Haygood v. Commissioner*, 42 T.C. 936 (1964), and *Estate of Kelley v. Commissioner,* 63 T.C. 321 (1974).

The court distinguished *Haygood* and *Kelley* in a §2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. *Estate of Maxwell v. Commissioner,* 3 F.3d 591 (2nd Cir. 1993). Several other cases have distinguished *Haygood* and *Kelley* in other contexts, observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth. *E.g., Miller v. Commissioner*, T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997); *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 664 (1995).

The better approach seems to be that, even if there is an intent to forgive the note payments from the outset, the transfer should not be treated as a gift initially. (1) The donor 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.

5. Structure Loan as a Bona Fide Loan

a. *Significance*. The IRS may treat the transfer as a gift, despite the fact that a note was given in return for the transfer, if the loan is not bona fide or (at least according to the IRS) if there appears to be an intention that the loan would never be repaid. (If the IRS were to be successful in that argument, the note should not be treated as an asset in the lender's estate.)

A similar issue arises with sales to grantor trust transactions in return for notes. The IRS has made the argument in some audits that the "economic realities" do not support a part sale and that a gift occurred equal to the full amount transferred unreduced by the promissory note received in return. Another possible argument is that the seller has made a transfer and retained an equity interest in the actual transferred property (thus triggering §2036) rather than just receiving a debt instrument.

b. *Structuring Loan So It Is Recognized*. The IRS presumes a transfer of money to a family member is a gift, unless the transferor can prove he received full and adequate consideration. Avoid the IRS gift presumption by affirmatively demonstrating that at the time of the transfer a bona fide creditor-debtor relationship existed by facts evidencing that the lender can demonstrate a real expectation of repayment and intention to enforce the debt. Treatment as a bona fide debt or gift depends on the facts and circumstances.

Summary: Structuring and Administration of Loan to Avoid Gift Presumption.

- Sign a promissory note
- Establish a fixed repayment schedule
- Set a rate at or above the AFR in effect when the loan originates
- Secure or collateralize the debt
- Demand repayment
- Maintain records that reflect a true loan transaction
- Repayments are made
- Borrower solvency
- Do not have a prearranged schedule to forgive the loan

6. Use an Interest Rate At Least Equal to the AFR for Cash Loans

a. *AFR*. The United States Supreme Court held in *Dickman v. Commissioner* that interest-free loans between family members are gifts for federal gift tax purposes, even if the loans are payable on demand. *Dickman* did not address how to value the gift. Sections 1274 and 7872 were enacted soon after the *Dickman* case. Those sections deal with valuing gifts and imputed interest income from below market loans. The statute seems to contemplate cash loans, but under case law the exchange of property for a note is also determined under §7872 and as long as the loan bears interest at a rate equal to the AFR for the month in question, there is not a deemed gift attributable to the note.

A demand or term loan with an interest rate at least equal to the AFR (determined under §1274) is not a below market loan. The AFR schedules are published each month on about the 20th day of the month. (One way of locating the AFR for a particular month is to search for "AFR" on the IRS website (www.IRS.gov). In addition, planners can register on the IRS website to receive a monthly notification of the AFR from the IRS.)

b. *Summary of Effects of Using AFR*. Forgone interest is computed by taking the present value of all payments due under the loan (discounted using the appropriate AFR) and compare it to the actual loan amount; if the resent value is less, there is forgone interest.

Forgone interest is deemed to have been transferred from the lender to the borrower as a gift, and then from the borrower to the lender as interest income.

Income tax treatment: The forgone interest is imputed as interest income on the last day of each taxable year.

Gift tax treatment: For demand loans, the foregone interest each year is deemed to be given on December 31 (or when the loan is repaid). For term loans, 100% of the foregone interest is treated as a gift upfront when the loan is made.

Avoid those complexities by using an interest rate at least equal to the AFR for all loans.

c. *Exceptions When AFR Is Not Needed*. There are two special rules where interest does not have to be charged on the loan at the AFR to avoid imputed income or gift tax.

Exception for $10,000 Loans (Gift and Income Exception). In the case of gift loans there is an exception for loans where all loans between those same individuals do not exceed $10,000 and if the loan is not directly attributable to the purchase or carrying of an income-producing asset. In that case, there is no deemed transfer for income or gift tax purposes for any day during which the aggregate outstanding amount of loans between those individuals does not exceed $10,000. §7872(c)(2).

Exception for $100,000 Loans (Income Exception Only). If the aggregate outstanding amount of gift loans between individuals does not exceed $100,000, the imputed interest amount (i.e., the amount treated as retransferred from the borrower to the lender at the end of the year) for income tax purposes is limited to the borrower's net investment income for the year. §7872(d). However, there is a de minimis rule: if the borrower has less than $1,000 of net investment income for the year, the net investment income for purposes of this exception is deemed to be zero (so there would be no imputed income from the loan during that year).

7. 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. (1) There is no complexity of repeatedly determining the appropriate AFR for any particular period, but the AFR at the origination of the loan controls. (2) 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.

8. How to Determine Interest Rate for Demand Loans and Term Loans

a. *Demand Loans.* For demand loans, the below-market interest amount (that is treated as transferred from lender to borrower for income and gift tax purposes) is determined for each semiannual period based on the short-term AFR at the beginning of that semiannual period less the interest that is actually due under the note and paid for that period. In order to avoid having imputed income and gifts with demand loans, the note often provides that the interest rate will be the appropriate short-term AFR for each relevant period so that the note is not a below-market loan.

If the note provides that the interest rate will be the relevant AFR for each particular period, the appropriate AFR will have to be determined over relevant periods (as described below) to calculate the amount of interest due under the note. If the demand note does not call for interest to be paid at the ever-changing relevant short-term AFR, such AFR will have to be determined in any event to determine the amount of imputed income and gift from the below-market loan.

For the semiannual period in which the loan is made, the short-term AFR in effect on the day the loan is made is used. For each subsequent semiannual period (January-June and July-December), the short-term AFR for the first month of that semiannual period (i.e., January or July) is used. Prop. Treas. Reg. § 1.7872-3(b)(3)(i)(A). (However, "Example 5" in the regulations suggests that the lowest short-term rate in the semiannual period [from and after the month in which the loan is made] may be used.) Prop. Treas. Reg. 1.7872-3(b)(3)(i)(B)Ex.5(iii).

Accrued interest (not forgiven) is treated as a new loan and payments are applied to accrued interest first, then principal.

Summary.

- New Loans – the lower of the short-term AFR in effect the month the loan is made or the 1st month of the semiannual period (January or July)

- Rate is reset every 6 months to the short-term AFR for January and July
- For loans that remain unchanged during the year, the interest is computed using the annual Blended rate (Published annually in July AFR ruling issued about June 20 – the 2011 Blended Rate is 0.40%)

b. *Term Loans*. For term loans, determining the appropriate AFR is much easier. Simply use an interest rate that is equal to the AFR with the same compounding period for the month in which the loan is made. For sale transactions, the interest rate on the note can be the lowest AFR for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange." For sale transactions the appropriate AFR is based not on the term of the note, but on its weighted average maturity. §1274(d)(2)(3-month provision); Treas. Reg. § 1.1274-4(c)(weighted average maturity description).

Summary.

- The appropriate AFR is the rate in effect for the month the loan is made based on the term of the loan: short-term (3 years or less); mid-term (over 3 years but less than 9 years); long-term (over 9 years)
- The rate continues to apply over the life of the loan despite future rates fluctuation.

For sales transactions, the lowest AFR for the 3 months ending with the sale date can be used.

9. 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 ability to repay was only one of nine factors examined in *Miller v. Commissioner* (T.C. Memo. 1996-3), but there is significant danger that a loan to someone without the ability to repay the loan may not be respected as a loan. Cases involving the application of §2036 to private annuities to trusts and individuals also emphasize the importance of using trusts or individuals who have the ability to repay the debt.

Summary. 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. (However, observe that there is no requirement of having any minimum equity in certain trust transactions that are recognized by regulations, including GRATs and CLATs.)

10. Accrued Interest Generally Must be Recognized Each Year Even by Cash Basis Taxpayers

For below-market gift loans, the forgone interest demand loan rules apply. (Although §7872 says that a term loan with a below-market interest rate will be treated as having original issue discount ["OID"] at the time the loan is made, the proposed regulations say that for gift below-market term loans the forgone interest demand loan rules apply.) Each year, a lender must report the interest income imputed to the lender under §7872, with a statement explaining various details.

What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under §7872. Nevertheless, if interest accrues but is not actually payable, the original issue discount (OID) rules will apply, and they generally require that a pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. The amount of OID included in income each year is generally determined under a "constant yield method" as described in the §1272 regulations. Treas. Reg. §1.1272-1(b)(1).

There are a variety of exceptions from the OID rules; for example, the OID rules do not apply to a loan if it is not made in the course of a trade or business and if all outstanding loans between the lender and borrower do not exceed $10,000. For seller financed notes, there are additional exceptions including sales of farms for $1 million or less by individuals or small businesses, sales of principal residences, sales involving total payments of $250,000 or less, and notes given in sales transactions under a certain amount (about $3.8 million in 2012) that the buyer and seller agree to treat as "cash method debt instruments." §§1274(c)(3), 1274A(c)(1). However, in most intra-family loan situations, the OID rules will apply.

The key to this analysis is determining the overall amount of OID over the life of the loan. Original issue discount is the excess (if any) of the "stated redemption price at maturity" over the" issue price." The "stated redemption price at maturity" is the sum of all payments provided for by the debt instrument except for qualified stated interest payments (but in most intra-family loan situations where there are interest accruals, there will not be any "qualified stated interest"). Therefore, in most common situations, we start with the sum of all payments provided for by the debt instrument. From that, the "issue price" is subtracted to determine the amount of OID. For cash loans, the "issue price" is the amount loaned. For seller financed transactions, there is a different more involved computation of the "imputed principal amount," but if the note has stated interest equal to the appropriate AFR, the stated principal amount of the note is the issue price that is subtracted. Therefore the OID would be the total interest payments that would be due under the loan over the life of the loan if the stated interest equals or exceeds the relevant AFR.

Summary. A pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. After working through the technical details, the OID is the total interest payments that would be due under the loan over the life of the loan if the stated interest equals or exceeds the relevant AFR.

The OID income is reported ratably over the life of the loan, whether or not the interest is paid, even if the lender is a cash basis taxpayer. The OID complications are avoided if the loan/note transaction is between a grantor that that person's grantor trust.

11. Forgiving Debt Should Not Result in Income Recognition to Borrower and May Not Result in the Seller Having to Recognize Accrued But Unpaid Interest as Income

The borrower should not have discharge of indebtedness income if the note is forgiven because §102 excludes gifts from the definition of gross income.

The seller may not have to recognize accrued interest as income. By negative implication, the proposed regulations indicate that accrued interest under a note providing stated interest will not be recognized as income if the accrued interest is forgiven as long as the forgiveness "include[s] in substantial part the loan principal." Prop. Reg. § 1.7872-11. The proposed regulations have been outstanding for decades but have never been finalized. However, these regulations appear to provide a reporting position that the waived interest would not have to be recognized as imputed income by the lender.

The following are various limitations and uncertainties regarding the ability to avoid recognizing accrued but unpaid interest by forgiving the interest.

a. *Current Year Accrued Interest Only*? Only the current year accrued income may avoid recognition under the forgiveness approach if any accrued interest in earlier years had to be recognized in those earlier years.

b. *How Much Principal Must be Forgiven*? There is inherent ambiguity over how much of the principal must be forgiven when the accrued interest is forgiven. The regulation uses the nebulous phrasing that the forgiveness includes "*in substantial part* the loan principal." The language of the proposed regulation seems to refer to the principal forgiveness being a substantial part *of the forgiveness* and not a substantial part of the total loan principal.

c. *Proposed Regulation*. This position is based merely on a proposed regulation that has never been finalized. But the fact that the proposed regulation has stood unchanged for decades and that there has been no case law rejecting this analysis over those decades provides comfort. Proposed regulations may be considered to determine if there is substantial authority for purposes of avoiding taxpayer or preparer penalties.

e. *Consistently Forgiving Accrued Interest Each Year May Not be Advisable*. If the accrued interest must be recognized each year under the OID rules, the only way to avoid the recognition of all interest under the note would be to forgive the accrued interest each year (in connection with a forgiveness in substantial part of the loan principal). However, if the accrued interest is forgiven each year, that is a factor that may be considered in refusing to recognize the loan as a bona fide loan rather than as an equity transfer.

Summary: Forgiveness or cancellation of an intra-family note does not result in discharge of indebtedness income to the borrower (if the borrower is insolvent or if the forgiveness/cancellation is a gift). Proposed regulations provide an argument (by negative inference) that the lender will not have to recognize the unpaid interest (that has not previously been recognized under the OID rules) that is forgiven if the forgiveness includes "in substantial part" the loan principal. Do not consistently forgive accrued interest each year; that may be a factor in determining whether there is a bona fide loan.

12. Discounting Notes in Subsequent Transactions *May* Be Possible—But Not for Weak Stomachs

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 or date of maturity) or is uncollectible in whole or in part. A wide variety of cases have valued notes at a discount from face based on satisfactory evidence.

Gift Tax Purposes. Under §7872, the gift amount of a below-market loan is the forgone interest, or the amount by which the interest under the note is less than the AFR. Section 7872 does not address other factors that may impact the value of the notes—it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. The statute does not address the gift tax implications of a note that has an interest rate that is equal to or greater than the AFR. However, the clear implication of §7872 is that a transfer for a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Even following the adoption of §7872, the value of notes apparently can be discounted because of factors stated in the general gift tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with §7872 that purport to override the general gift tax valuation principles for notes under Reg. § 25.2512-4.

Estate Tax Purposes. The general estate tax regulation regarding the valuation of notes provides that the estate tax value is the amount of unpaid principal plus interest accrued to the date of death, unless the executor establishes that the value is lower by satisfactory evidence that the note is worth less than the unpaid amount (e.g., because of the interest rate or the date of maturity) or that the note is uncollectible by reason of insolvency of the maker and because property pledged as security is insufficient to satisfy the obligation. Reg. §20.2031-4. Therefore, the note can apparently be discounted based on the note's interest rate if interest rates generally rise by the time of the holder's death.

Even if general interest rates do not change between the time the note is given and the date of death, can the note be discounted because the AFR, which is the test rate for gift tax purposes under §7872, is an artificially low rate — the rate at which the United States government can borrow? There are no cases or rulings. A proposed regulation under §7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed. Prop. Reg. §20.7872-1. However, that regulation has never been finalized. *Be aware,* h*owever*, the IRS estate tax agent may feel that taking a discount merely for this reason is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the loan or sale transaction. Also, beware that the income tax effects of discounting the note may offset or even outweigh discounting the note for estate tax purposes. When the note is paid, the excess payment over the note's basis is generally treated as ordinary income.

Summary: 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. 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.

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 purposes. However, the IRS fights that argument. Furthermore, when paid the excess payment over the note's basis will be treated as ordinary income in most circumstances.

13. Refinancing Notes to Utilize Lower Interest Rates

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. Commentators have generally concluded that refinancings at lower AFRs should be possible without gift consequences.

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 an equity 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.

Some advisors renegotiating the terms of notes not only adopt the lower more current AFR, but also compensate the lender in some say for accepting the lower rate, "perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral."

Summary: Refinancing at lower current interest rates should be permissible, but do not get greedy and do this repeatedly. To be more conservative, make some modification in return for the lender's agreeing to refinance at the lower interest rate, such as paying down some principal, reducing the term of the loan, or adding collateral.

14. Best Practices Summary

The following is a brief 10-point checklist of best practices in structuring intra-family loans.

1. Have the borrower signed a promissory note.
2. Establish a fixed repayment schedule.

3. Charge interest at or above the minimum "safe harbor" rate.

4. Request collateral from the borrower.

5. Demand repayment.

6. Have records from both parties reflecting the debt.

7. Show evidence that payments have been made.

8. Make sure that the borrower has the wherewithal to repay the loan.

9. Do not establish any plan to forgive payments as they come due.

10. Refinance with caution.

15. Planning Issues With SCINs

a. *Overview*. A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling the liability upon the death of the holder. If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder.

Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner*. 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under § 2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note."

The potential advantages of using SCINs for estate tax savings may be further enhanced by "backloading" the payments. That may result in a significantly smaller amount being paid to the seller during life and with a greater amount being cancelled, thus resulting in exclusion of more value from the seller's gross estate. A potential disadvantage of the SCIN transaction is that if the seller outlives his or her life expectancy, the premium that is paid for the cancellation feature may result in more value being included in the seller's estate than if the cancellation provision had not been used.

b. *Determining Cancellation Premium*. The IRS has never given guidance as to how to calculate the premium attributable to the cancellation feature of the note. There are no PLRS explainginin the mathematics. Three commercial software programs, ZCalc, Tiger Tables (developed by Larry Katzenstein) and Leimberg's NumberCruncher all reach the same answer, and they all calculate the premium independently. Larry said that the IRS probably uses the same software programs to calculate the premium as the rest of us use.

What interest rate is used to calculate the premium—the §7520 rate, the §1274 rate or some other rate?

What life expectancy tables are used? Possibilities are the §72 return multiples (which are longer life expectancies) or the life expectancy tables referenced in §7520. Larry thinks the mortality assumptions under section 7520 clearly should be used, because they apply for gift tax purposes the §72 rules apply in determining income taxation of annuities. A GCM used the §72 mortalities (which would produce a lower premium). A counterargument is that §7520 mandates use of the mortality tables under §7520 except as provided otherwise in regulations, and the regulations do not say otherwise. For example, for a charitable gift annuity, they are used to determine the income tax treatment of the annuity but §7520 is used to calculate the charitable deduction. The situation should be analogous for determining the cancellation premium. All three of the commercial software programs use the §7520 life expectancy assumptions.

An interesting anomaly is that, with interest rates as low as by our currently, for some pages in terms the commercial software indicate that the cancellation premium is zero—and we know that can't be right. For example, if the §7520 rate is 1.4% and the market interest rate is 2%, the maker is 50 years old and a 10-year term note is used, all of the commercial software packages indicate the cancellation premium is zero. There must be some premium in that case, but Larry has no clue how to calculate it.

c. *Income Tax Effects of Cancellation to Seller's Estate.* If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. The primary question is whether the deferred gain is properly includible (a) on the deceased seller's final return, in which event the resulting income tax liability should be deductible as a §2053 claim against the estate for estate tax purposes, or (b) in the initial return of the deceased seller's estate as an item of income in respect of a decedent ("IRD") under §691. In *Estate of Frane v. Commissioner,* the Tax Court held the income would go on the deceased seller's final return, 98 T.C. 341, 354 (1992), but the Eighth Circuit reversed and held that the estate would realize the income, 998 F.2d 567 (8th Cir. 1993). The Eighth Circuit's position has not been adopted by any other Circuits. An argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and §453B(f).

There is uncertainty regarding the determination of the note's basis. Is it the amount of the payments as determined initially or if the note is canceled because the person dies before the end of the note term, is the basis the total amount actually paid?

c. *Do SCINs Still Make Sense When Estate Tax and Income Tax Rates Are About the Same?* If the seller dies before all note payments have been paid, the net effect is that the amount of the unpaid payments is excluded from the gross estate for estate tax purposes, but is treated as income for income tax purposes. As the estate and income tax rates become closer in amounts, does using SCINs make sense? There is a net advantage, even if the estate and income tax rates are the same, because, the estate tax savings is based on the entire amount of the remaining payments whereas the income tax cost is based on just the amount of taxable income, which is the amount of the remaining payments less basis attributable to those payments. For example, if a high basis asset is sold, the income tax cost may be relatively small.

16. Loans Involving Estates; Graegin Loan Planning Considerations

a. *Significance*. 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 9 months after the date of death. 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. On other side of the coin, (and of less importance) there may be situations in which beneficiaries need advances, before the executor is in a position to be able to make distributions.

b. *Recent Cases*. In *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. T.C. Memo. 1988-477.

An interest deduction was allowed on a Graegin loan in *Estate of Duncan v. Commissioner,* T.C. Memo. 2011-255. A revocable trust (responsible for paying estate taxes) borrowed funds from an almost identical irrevocable trust. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The estate claimed a deduction under §2053 of about $10.7 million for interest that would be payable at the end of the 15-year term of the loan, which the court allowed because (i) the loan was bona fide debt, (ii) the loan was actually and reasonably necessary, and (iii) the amount of the interest was ascertainable with reasonable certainty.

A deduction was similarly allowed in *Estate of Kahanic. T.C. Memo. 2012-81. T*his case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053. The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short-term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial because (i) the loan was bona fide debt, (ii) the loan was actually and reasonably necessary, and (iii) the interest will be paid by the estate.

c. *New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans*. The §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.

d. *Financial Implications of Graegin Loan Transactions*. Alternatives for generating cash to pay estate taxes include (1) selling estate assets, (2) obtaining a §6166 deferral (in effect, borrowing from the government), (3) borrowing from a related family entity with a Graegin loan, and (4) (4) borrowing from a third-party vendor with a Graegin loan.

Advantages and disadvantages of the various approaches are summarized.

Selling assets. Advantages are that there are no financing costs and there should be minimal capital gains (because of the basis step up at death). Disadvantages are that the estate gives up potential future appreciation from the sold assets, and valuation discounts associated with those assets may be jeopardized by a quick sale after death.

Section 6166 deferral. Advantages are that there would be no impact on valuation discount for estate assets, and the loan could be prepaid at any time without penalty. Disadvantages are that the term and interest rates are not negotiable (though the interest rate is very low-being 45% of the normal IRS underpayment interest rate), and the interest rate is a variable rate rather than being able to lock in the current very low rates over a long-term period.

Intra-family Graegin loan. Advantages are that the interest rate can be tied to the AFR (but it could be higher if desired to generate a higher estate tax deduction as long as it is still commercially reasonable), and there is more flexibility in negotiating terms of the note with a related entity (collateral requirements, financial covenants, etc.). A disadvantage is that the family related entity gives up the potential future appreciation on the assets used to fund the loan. Another disadvantage is that an intrafamily Graegin loan comes under much greater scrutiny from the IRS than a loan from a third party lender.

Third-party lender Graegin loan. A significant advantage is that there is less scrutiny from the IRS regarding the deductibility of interest as an estate tax administration expense. A disadvantage is that there will obviously be significant because Scioscia's regarding terms of the note with a third party lender. Typical restrictions include that the estate not incur any additional indebtedness, the estate cannot create any additional liens against estate assets, that you liquid assets of the estate (to which the bank will be looking for repayment of the loan) maintain certain liquidity levels, and typically no distributions are allowed to beneficiaries until the loan is repaid.