IntraFamily Loans - A Primer

Take-Away: Intrafamily loans can be an effective way to shift wealth to lower family generation members without incurring any gift tax.

Background: One relatively easy way for family members to shift wealth without gift tax implications is to engage in intrafamily loans, which are a straightforward and efficient way to transfer wealth among family members. That said, there are several rules and presumptions that the lender needs to be aware of when he/she makes and documents the loan.

Loan or Gift? Federal courts apply at least 9 factors to distinguish between a gift and a loan. *Estate of Bolles, Tax Court Memo 2020-71, aff'd Docket No. 22-70192 (9th Cir, 2024.)* An intrafamily loan should, among other things, be documented in writing, charge interest, include a repayment schedule (manifesting an expectation of repayment of the loan), and have a definite maturity date. In short, the loan should be documented and treated in a manner that is consistent with a bona fide debtor-creditor relationship.

Special Scrutiny: Transactions within a family group are subject to special scrutiny and the presumption is that a transfer between family members is a taxable gift. *Harwood v. Commissioner, 82 Tax Court 239 (1984).* In the case of a loan to a family member, the presumption of a gift can be rebutted by an affirmative showing that at the time of the loan the lender had a real expectation of repayment and an intention to enforce the debt. *Lockett v. Commissioner, Tax Court Memo, 2012-123 (2012).*

Below Market Interest: IRC 7872 treats below-market interest loans as taxable gifts for federal gift tax purposes. However, if the loan's interest rate is consistent with the then prevailing applicable federal rate [IRC 1274, published monthly] at the time the loan is made, the loan will be presumed to be at market-rate, and therefore the loan will avoid any adverse tax consequences from being an intrafamily loan.

History: IRC 7872 was introduced in 1984 in response to the Supreme Court's decision in *Dickman v. Commissioner,* which held that the use of a lender's money is a 'valuable property right' that is transferred for gift tax purposes when a lender makes a *demand* loan for no interest. However, *Dickman* did not address the gift tax consequences of term loans.

IRC 7872: Congress chose IRC 7872 to address the treatment of all 'gift loans' after *Dickman,* including both demand loans and term loans. In the case of term loans, IRC 7872 codified the principle that a term loan is a gift to the extent that the amount lent exceeds the present value of the payments required to be made under the terms of the loan. But by providing a 'safe harbor' tied to the AFR in IRC 7872, Congress in effect also permitted lenders to make term loans and charge interest at a rate, specifically the AFR, that is often below market in the real world. As the Tax Court subsequently noted in *Frazee v. Commissioner, 98 Tax Court 554 (1992) "The application of IRC 7872…is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept."* In sum, once a loan escapes classification as a below-market loan under IRC 7872, the interest charged will be deemed to be a market rate of interest, and its lender will avoid being considered to have made a taxable gift.

Demand Loans: A demand loan is fair more difficult to deal with than a term loan. The computation of interest in compliance with IRC 7872's methodology is much more complex. In addition, if it is a demand loan, and under state law it becomes unenforceable from a lapse of time, the lapse is treated as a taxable gift. [Revenue Ruling 81-264.] Also, if a demand note is issued in exchange for property because it is less common in a commercial context, it may be more vulnerable to being recharacterized as a gift.

AFRs: The problem with connecting the intrafamily loan's interest rate to the then applicable federal rate of interest (AFR) is that to achieve the greatest shifting of wealth with the intrafamily loan, the loan's AFR rate should be as low as possible, and the loan's duration should be as long as possible. The short-term AFR (less than 3 years) usually provides the lowest interest rate, and the long-term AFR (9+ years) usually provides the highest interest rate (the most recent period where short term rates were higher being an exception to this general observation.) Consequently, using the AFR 'safe harbor' for the intrafamily loan's interest rate may not produce the best result with a term intrafamily loan, juggling short-term rates with long-term payment horizons. That said, there might be a 'best of all worlds' result with an intrafamily loan if a variable rate term intrafamily loan is made.

Variable Rate Intrafamily Loan: A variable rate term loan may combine the lowest possible rates with the longest possible duration term. IRC 7872 does not mandate that intrafamily loans must exclusively use fixed AFR rates. IRC 7872 will not apply to a loan provided that the rate is not lower than the AFR when the loan originates. To determine which AFR is used to test the initial variable rate, the Regulations require looking at the frequency at which the loan's interest rate, if variable, is reset according to its benchmark index. Variable rates tied to a specific index will fluctuate over time, and the interest rate applied to the loan must be adjusted accordingly to reflect the changes in the index over time. In short, variable loans using the short-term AFR rate will typically include specific adjustment

periods to reflect the most recent changes to the specific index to which it is tied. The Regulations thus provide rules that open the door for more optimal intrafamily loans, by permitting long-term loans to enjoy the benefits of the usually lower, short-term AFR, by virtue of a periodically changing short-term AFR rate. Including a refinancing provision in the fixed rate promissory note may also be wise because the parties may want to eventually turn the fixed rate intrafamily loan into a variable rate loan if economic indicators suggest overall rates will decline.

Conclusion: For those who have fully used their applicable exemption amount with lifetime gifts, who still want to transfer wealth to family members, an intrafamily loan should be considered. As interest rates begin to fall if the Federal Reserve is true to its word, then families should look at the use of intrafamily term loans using a variable rate of interest, tied to the short-term AFR rate. Intrafamily loans are straightforward. They are simple to document and understand. Yet intrafamily loans can shift substantial wealth to borrowers with no gift tax exposure to the lender if the loan's interest rate is always tied to the AFR.

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