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Summary of Advantages of Intra-Family Loans
in Low Interest Rate Environment

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Intra-family loans can be an effective estate planning tool to transfer wealth to the next generation (likely one's children or grandchildren) in order ultimately to avoid or minimize gift or estate tax exposure. If a donor, however, makes an interest free gift to a donee, the Internal Revenue Service will treat the foregone interest as a taxable gift. Consequently, to avoid gift tax consequences to the donor, intra-family loans should be created with an interest rate that follows the Applicable Federal Rate (AFR) guidelines, as defined by the Internal Revenue Service.

In the current interest rate environment, the AFR to be applied to a loan (to avoid any gift tax issues) is historically low. Intra family loans produce a benefit for the donor's family if the borrowed funds can be reinvested to produce a total return rate in excess of the AFR of the loan. Consequently, to the extent that the donee is able to invest the borrowed funds at a higher rate of return than the interest rate being paid (AFR) on such borrowed funds to the donor, the donor will have successfully transferred the excess interest earned on the loan out of the donor's estate. Furthermore, the donee is able to keep the excess interest earned on the loan without any gift tax consequences to either the donor or the donee.

The following example illustrates the tax advantages associated with intra family loans in a low interest rate environment.

In March of 2012, the AFR for a loan with a maturity of more than three years but less than nine years, is 1.08 percent. If a Father lends to his Son $1,000,000.00 at a rate of interest of 1.08 percent (March 2012 mid-term AFR) that is due in eight years, Son will owe Father principal and interest on the loan totaling $1,089,737.00 at the end of the eight-year period. Assuming, however, that Son invests the $1,000,000.00 that he borrowed from Father in an investment vehicle that over the eight-year period earns an average yearly return of 8.00 percent, Son will have a total of $1,850,930.00 to pay off the loan. Consequently, Father will have successfully transferred $761,193.00 ($1,850,930.00 minus $1,089,737.00 equals $761,193.00) of assets from his estate to Son without incurring any gift tax consequences.

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