CHAPTER 39

Intra-Family Loans

SEAN KENNEY (San Francisco, California)

Bank borrowing is a common method for obtaining a loan. However, banks may not always be practical sources for funds for children and other heirs. The following example illustrates this principle. Assume Laura and Lenny, a married couple, have accumulated wealth of $50 million. Their son Bruce, 23, recently found a wonderful place in the Hamptons costing $2 million that he feels he must own. Laura and Lenny love Bruce so much they have offered him any type of assistance in buying a home. In fact, Laura and Lenny have told little Bruce they would purchase the home for him outright if only they had not already exhausted their available gift tax exemption buying him gold-plated GI Joe action figures last year.

Bruce acquired his parents' business acumen and recently launched a successful chain of Bolly Burgers, netting approximately $250,000 annually. However, Bruce's credit is poor, due to failed business ventures in the past, and banks refuse to lend him any money. Laura and Lenny love little Bruce dearly, but do not want to pay any transfer taxes this year so they refuse to buy a home for Bruce outright. What is Bruce to do?

Bruce has a couple of options: 1) go to the neighborhood loan shark and obtain a loan at a 30% annual interest rate; or 2) borrow money from Laura and Lenny. Wisely, Bruce has opted to choose the latter. Laura and Lenny want to ensure no tax exposure results from this transaction, but also want to give Bruce the best possible loan terms. Thus, Laura and Lenny decide to seek counsel from their attorney.

To their dismay, their attorney advises Laura and Lenny that they cannot make a $2 million loan interest-free. The United States Supreme Court has held that any type of transfer of property or property rights — such as an interest-free loan — with substantial value is deemed a gift and the interest not charged is still treated as income. Thus, if Lenny and Laura make a loan to Bruce interest-free, when in fact the applicable rate should be 5% annually, they could be taxed on a $100,000 gift at the federal gift tax rate of 45% ($45,000) for every year the loan exists. Lenny and Laura would also have to treat the interest they would have received ($100,000) as income taxed at their income tax marginal rate of 35% ($35,000). Reluctantly, Laura and Lenny agree to loan little Bruce $2 million at an annual interest rate of 5%, thereby avoiding the gift tax but not the income tax.

Having diligent business minds, and recognizing that the IRS may still attempt to impute a gift based upon the nature of the relationship between themselves and

Bruce, Laura and Lenny inquire how they may make the consequences of this transaction more certain. Their attorney advises them that a promissory note, security agreement, and guarantee agreement will document the transaction. These steps will avoid problems with the IRS. However, Laura and Lenny have no idea what these types of documents are, or what they mean.

A promissory note recites the terms, amount, and the interest rate of the loan in question. A promissory note also discusses what will happen if the borrower, here Bruce, decides to default on the loan. The promissory note may be interest only with a balloon payment at the end, which greatly interests Bruce, as he can only afford to make small payments at the current time.

The promissory note needs to be "secured" in the case of default by Bruce. Put simply, if Bruce fails to meet the obligations spelled out in the promissory note, Laura and Lenny can take (foreclose upon) the Hampton house and sell it to pay off any type of obligation owed to them by Bruce. Thus, if Bruce made interest and principal payments throughout the term of the loan, and owed $1 million on the principal balance, then upon Bruce's "default" (failure to pay when due), Laura and Lenny could foreclose and sell the house for $2 million. In that instance, Laura and Lenny would only be entitled to receive $1 million. The remaining amount would go back to Bruce, who could buy a more modest house loan free.

Finally, a guarantee agreement allows for a third party to act as guarantor for little Bruce's loan. Laura and Lenny could proceed against the third party without proceeding against Bruce on the loan if he defaults. A guarantee agreement is especially useful if, for example, the Hampton house burned down due to Bruce's playboy lifestyle, and Bruce owed Laura and Lenny close to all of the principal on the loan. Under these circumstances, Laura and Lenny could proceed against a third party to collect any debt owed to them. Of course, Laura and Lenny would not want to proceed against Bruce at all in such circumstance (or his guarantor). However, if they did not proceed against Bruce or the third-party guarantor in such a situation, any amounts uncollected would be viewed as a gift and taxed accordingly.

Laura and Lenny are glad they spoke with their attorney and they enter into an agreement to loan little Bruce $2 million for a term of 30 years at a rate of 5% annually. Bruce will make interest-only payments for the first 29 years of the loan, with the remainder to be paid on the 30th anniversary of the promissory note. The note is secured by Laura and Lenny taking an interest in the home, and the loan is guaranteed by Bruce's childhood friend, Bob, who has also done quite well for himself. Bruce is extremely happy he did not have to get a loan for his home at a 30% rate from the loan shark. Laura and Lenny are doubly glad they did not have to pay any gift tax. Everybody comes out ahead, except the IRS of course.

For smaller loans, the benefits are even greater. Loans of $10,000 or less are not subject to the gift tax and income tax treatment of interest-free loans. The imputed gift and income from loans between $10,000 and $100,000 is limited to the lesser of the investment income of the borrower (Bruce) or the applicable federal rate.

If Bruce used the loan proceeds to buy the house or attend graduate school, earning no investment return, no income is imputed to the parents.

Sean R. Kenney, Myers Law Firm, P.C., provides estate, tax, and business succession planning.