The Legal Intelligencer

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The Role of Inter-Family Loans in Estate Plans

For many reasons, parents may not always want to completely part with gifts of funds to their children until their deaths, and may decide that making a loan would be more consistent with their overall objectives.

By **Rebecca Rosenberger Smolen and Amy Neifeld Shkedy** | February 28, 2022

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The simplest way for parents to financially help out their children is to give them gifts of cash, no strings attached. That is sometimes, although not always, optimal from a federal gift and estate tax and Pennsylvania inheritance tax, perspective. However, for many reasons, parents may not always want to completely part with gifts of funds to their children until their deaths, and may decide that making a loan would be more consistent with their overall objectives.

As a backdrop, it's worthwhile to understand the tax benefits/detriments of making gifts as opposed to loans. While Pennsylvania has an inheritance tax at death (with no exemption threshold amount), there is no Pennsylvania gift tax for assets given away during lifetime. Thus, for Pennsylvania transfer tax purposes, a gift made more than one year before death, plain and simple, is not subject to any gift tax or Pennsylvania inheritance tax on death. On the other hand, for federal purposes, there is a unified federal gift and estate tax system so that large gifts made during lifetime (in excess of the $16,000 per donee annual exclusion gifts) could potentially incur a gift tax if the gift amount exceeds the federal exemption amount and, in any case, the gift will reduce the estate tax exemption available at death (the current exemption amount being $12.06 million for an individual or $24.12 million for married couples). For the fewer and fewer estates that are subject to the federal gift and estate tax of such historically large exemption amounts, gifts can be a way to

leverage the time value of money. By giving away funds before death, the potential investment return on the funds can be shifted out of the taxable estate. This can be a meaningful tax savings when you consider that under the rule of 72, money will double every 10 years if it earns a return of 7.2%. So, with an investment return at that level, a gift of $1 million, would become $2 million over 10 years, and $4 million over 20 years. If a donor death occurs 20 years after the gift, at the current 40% estate tax rate, $1.2 million of taxes could be saved as a result of the gift.

For estates below the federal estate tax exemption threshold, however, a gift might end up generating additional taxes under the current federal tax laws. This is because currently, for capital gains tax purposes, the tax basis of assets is "stepped-up" to date of death values. So, if the capital gains rate is 20%, without a federal estate tax to save, the lost opportunity of securing a basis step up on $3 million of potential built in capital gain accruing over 20 years, in that last example, could cost the donee of the gift $600,000 of federal capital gains taxes that would have been avoided had the gift not been made. The Pennsylvania inheritance tax savings for the child taxed at 4.5% would be only $180,000, so, that savings would also be dwarfed by the loss of the tax benefit of a tax basis step up at death. In this situation, a loan rather than a gift may have been more advantageous to avoid the potentially large capital gains tax implications.

While it is helpful to be mindful of this technical backdrop, we find that it's very rare that a client consciously considers it in making a decision whether to make a gift or make a loan. The predominant reason for making loans rather than gifts is to keep tabs on the gifted funds for a multitude of reasons. Sometimes it's strictly a parenting decision. A typical objective of not spoiling a child and trying to help ensure that a child remains motivated to be productive in life and not overly rely on parents financially. Other times it's a concern about exposing gifted assets to a child's creditors, including a potential ex-spouse one day. When there are several children, the loan vs. gift decision is almost always driven by a desire to keep things as balanced as possible between the children in terms of gifting with the idea that it will all be "settled up" after both parents have died and the loan records are needed for that to happen properly.

It also must be recognized that sometimes loans are just a "win-win" for parent and child as a joint financial matter. These days interest on cash funds in CDs or money market accounts are negligible, often below 1%. And, even though mortgage rates are relatively low, they are generally at least 3% or higher (and inching up these days), so, a private mortgage loan can be a way for a parent to increase yield on cash, and for a child to reduce borrowing costs.

Under Internal Revenue Code Section 7872, it is generally a problem for gift and income tax purposes to issue an inter-family loan with a "below market" interest rate, otherwise there could be a deemed gift of the forgone interest, as well as deemed taxable income for the lender. So, the common practice is to state an interest rate of at least the applicable federal rate (AFR) which is published monthly by the IRS. As a point of reference, the rates for March 2022, for loans with annually compounding interest, are: 0.97%, 1.74% and 2.14% for short-term (less than three years), mid-term (three-nine years) and long term (greater than nine years) loans, respectively. These tax rules don't apply to loans under $10,000, or loans under $100,000 if the net investment income for the borrower is under $1,000 for the year (in other words, such loan could have an interest rate below the AFR, even a zero interest rate).

Another consideration in structuring loans is whether to amortize the payments of principal over a term or have the principal be due at the end of a term in a balloon payment. Sometimes loans are structured as demand notes as well. For loans that are used to finance the purchase or improvement of a personal residence, it is highly advisable to have them secured by a lien on the home—both to help protect the equity from potential creditors of the borrower (and correspondingly help secure repayment) and to qualify for the income tax deduction for any mortgage interest paid by the borrower.

Oftentimes loans remain outstanding at the death of the lender and become an asset of the estate during

administration. The natural approach is to allocate the loan to the share of the estate for the benefit of the borrower (so, for example, if a child had an outstanding loan balance owed to his or her deceased parent, part of that child's share of the parent's estate would be satisfied with the loan receivable attributable to that child to be fair to the other children). Sometimes the lender prefers to require this specifically in the appropriate estate planning documents to avoid any controversy about this typical desired allocation.

It is natural for parents to want to financially help out their children to the extent they can afford to do so. Generally, parents find it satisfying to see their children enjoy the use of gifted or loaned funds during their lifetimes as opposed to delaying that enjoyment until after they are gone. Whenever the funds involved are substantial, as we have discussed in this article, it is advisable to carefully consider a number of factors before concluding whether the funds transfer should be by way of gift or a loan.

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