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Intra-Family Loans and AFRs

July 20, 2008

The last paragraph of this letter has been prepared in accordance with Circular 230. Please review the last paragraph before reading this letter.

Intra-Family Loans are an effective way to shift wealth between family members. For those who routinely take advantage of annual exclusion gifts and want to convey additional tax-free wealth to family members, Intra-Family Loans should be considered. The transaction is premised on the assumption that the funds loaned will appreciate at a greater rate than the interest the IRS requires to be charged on the loan. The required interest rate is updated monthly by the IRS and is referred to as the Applicable Federal Rate ("AFR"). The July 2008 AFR for loans with a duration of three (3) years or less is 2.42% (increasing to 2.54% for and for loans given in August of 2008) and for loans of more than 3 years but not greater than 9 years the interest rate is approximately 3.45% in July (increasing to 3.55% in August 2008). Loans of greater than 9 years for the month of July require interest of 4.6% (and 4.58% for August) of 2008. These rates assume annual compounding.

To see how easily this transaction can work, consider a loan of $1 million to your children or a trust for your children. If the money grows by 7% annually, your children or the trust for their benefit will earn $70,000 per year and yet only owe $ 25,400 in interest (assuming a 3 year loan in August of 2008). The additional growth of $ $44,600 is a tax-free gift to your children (or to their trust).

AFRs are adjusted monthly and the interest rate for the upcoming month is typically published on the 20th of the prior month (e.g., the interest rate for September of 2008 will be released around August 20th, 2008). Planning requires only a simple promissory note. If the borrower is able to benefit from returns that exceed the interest charged the the borrower will have received a benefit from the loan transaction and the transfer of benefit will not be considered a gift as long as the AFR for the month the promissory note is entered into is charged and the terms of the note are compiled with. This is the case even if interest rates trend upward during the term of the loan.

This may also be an opportunity to consider refinancing intra-family loans that may have been made in the past at significantly higher interest rates. Any such negotiation should be at arm's length and if the interest rate is reduced, cautious taxpayers should consider having the borrower under the note should give the lender some type of consideration, such as a prepayment of a portion of the principal or a reduction of loan duration, in exchange for the reduction of interest rates to current AFRs. The link for the IRS site that reports monthly adjustments to the AFRs is at:

http://www.irs.gov/taxpros/lists/0,,id=98042,00.html