A Review of Income Tax Issues Associated With Intra-Family Loans & Installment Sales Series I of IV

For years, wealthy families and their advisors have utilized intra-family loans and installment sale transactions as part of an overall estate planning strategy to shift wealth tax efficiently between generations. In fact, installment sales of appreciating assets between grantors and grantor trusts in exchange for promissory notes have become one of the more common estate freeze techniques over the last several decades. The number of these transactions has exploded largely as a result of the low interest rate environment we've experienced since the early 2000's. Times are changing and interest rates are expected to be higher over the foreseeable future. Accordingly, we think it's important for clients and estate planning practitioners to review and reacquaint themselves with many of the income tax rules associated with these transactions to make sure intra-family debt doesn't produce unintended income tax consequences that could derail the transfer tax benefits sought to be achieved.

This paper is the first of a four-part series that will explore the following areas that clients and their tax practitioners should review given the higher interest rate environment and the impact higher interest rates could have on intra-family debt or installment sale transactions.

- **Series I**: A review of IRC Section 7872, Section 483, and the so-called original issue discount ("OID") rules, primarily under IRC Sections 1272-1274. Additionally, this part focuses on loans and debt transactions between trusts and their beneficiaries, including the possibility of below market or interest free loans from trusts to, or for the benefit of, their beneficiaries.

- **Series II**: A review of the income tax rules associated with reportable installment sale transactions under IRC Section 453, including dispositions of reportable installment obligations during life, as well as the rules under Section 691 governing dispositions of reportable installment obligations as a result of death.

- **Series III**: Post-mortem tax considerations involving loans between a grantor and their grantor trust that remain outstanding at the time of the grantor's death when the grantor trust converts to a non-grantor trust.

- **Series IV:** Loans and debt transactions between family members and non-grantor trusts or other separate taxpayers, including potential application of IRC Section 754 to step-up the inside cost basis of partnership or LLC assets if LLC or partnership interests are purchased in a taxable transaction (albeit under the installment method of reporting under IRC Section 453).

Click here for an expanded discussion of Internal Revenue Code Sections 7872, 483 and Sections 1272-1274 and the Treasury Regulations thereunder governing below market loans and transactions potentially subject to imputation of the original issue discount ("OID") rules.

Trust-Beneficiary Interest-Free Money Loans

As discussed more fully by clicking the above link, a non-gift loan might escape the application of Section 7872 if it falls outside one of the six enumerated categories. A loan between a trust and one of its beneficiaries is likely not subject to Section 7872 unless the arrangement is deemed to have a tax avoidance purpose and typically will avoid the application of the OID rules under Section 1273 if the stated redemption price at maturity is the same as the issue price. Treasury Regulations Section 25.2511-1(g)(1) provides, in relevant part, that the gift tax applies only to a transfer of a beneficial interest in property and further provides that transfers by a trustee of trust property in which the trustee has no beneficial interest does not constitute a gift by the trustee. In other words, when a trustee lends money to a trust beneficiary, the trustee is merely permitting the beneficiary to use property in which the beneficiary already has a beneficial interest. This essentially means that a trustee can't effectively make a gift and therefore the gift tax rules are inapplicable to treat transfers from a trustee to a beneficiary as a gift. If the trustee distributed cash to the beneficiary instead of making a loan, the resulting transfer to the beneficiary wouldn't be characterized as a gift but rather as a trust distribution. Accordingly, an interest-free or other below market loan from a trust to a beneficiary shouldn't be characterized as a gift loan.

Section 7872 provides that a below-market loan is a tax-avoidance loan if one of the principal purposes of the interest arrangement is the avoidance of any federal tax by either the borrower or the lender. This is a question of fact. The Joint Committee on Taxation's General Explanation of Section 7872 states that tax avoidance is a principal purpose of the interest arrangement if it is a principal factor in the decision to structure the transaction as a below-market loan instead of a loan requiring payment of interest equal to or exceeding the AFR. The proposed regulations under Section 7872 use similar language and further provide that the purpose for entering into the transaction (for example, to make a gift or to pay compensation) is irrelevant to determining whether a principal purpose is the avoidance of federal tax. In other contexts, courts have found that "a principal purpose" doesn't require the prohibited purpose to be the only purpose, but rather that the prohibited purpose weighed heavily.

The IRS has provided little guidance as to whether a below market loan will constitute a tax avoidance loan. There are certainly circumstances under which structuring a loan from a trust to a beneficiary as an interest-free loan may provide a tax benefit but it is not always clear if tax avoidance constitutes a principal reason for the loan. For example, if the beneficiary paid interest to the trust, the trust would be subject to income tax on the interest income. An interest-free loan that is not subject to Section 7872 avoids this tax. Even though an interest-free loan in this context may appear to be motivated by a tax avoidance purpose, such loans may also wind up being tax neutral if the borrower would have qualified for an interest expense deduction had interest been charged. Similarly, Section 7872 would not appear to apply if the borrower was able to show that the lack of interest on the loan doesn't have a significant tax effect on the lender or borrower. For example, a trust beneficiary would be entitled to a tax deduction for the payment of interest on a properly structured loan from a trust to the beneficiary for the purchase of investments. As a discretionary beneficiary of the trust, the beneficiary could receive a distribution of that interest income, in which case the beneficiary would report the interest income on their income tax return and offset that income with a corresponding interest expense deduction. Likewise, the trust would have interest income with a corresponding distribution deduction to the extent the distribution was made from distributable net income ("DNI"). In this example, there is no significant tax effect to the trust or the beneficiary.

Characterization of an interest-free loan as a tax-avoidance loan is a question of fact. In many cases, the circumstances may support a finding that the arrangement isn't tax motivated. Perhaps the trustee simply wants the beneficiary to have use of the loaned funds without having to be concerned about investing the funds

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in a way that provides liquidity for annual interest payments. As mentioned above, an example might include allowing the beneficiary to purchase an illiquid asset. There might be circumstances where an interest-bearing loan would negatively impact the ability of the beneficiary to qualify for a third-party loan arrangement or the additional interest payments might put a strain on the ongoing cash flow and working capital of the beneficiary's closely held family business. The trustee may also want to avoid the administrative and compliance burdens of collecting interest on a loan to a beneficiary, especially in cases in which the beneficiary is entitled to mandatory income payments or regularly receives most or all of the trust income that otherwise produces a DNI deduction at the trust level.

Accordingly, an interest-free loan arrangement may be appropriate in light of specific facts and circumstances. While not free from doubt, in many cases, the facts and circumstances may reasonably support a conclusion that an interest-free loan from a trust to a beneficiary isn't subject to Section 7872 and is therefore tax neutral for tax purposes.

Direct and Indirect Payments May Generate Additional Planning Opportunities

In many instances, trusts today with modern provisions allow trustees to make transfers directly to a beneficiary or alternatively to other persons or entities on behalf of a beneficiary. Additional planning may be achieved if one trust has more liquidity than another trust. A simple example might involve Trust #1 making an interest free loan to Trust #2 if both trusts primarily benefit the same beneficiary. No negative income tax consequences should result if the loan from Trust #1 to Trust #2 falls outside the application of Section 7872. Such an arrangement would also seem to constitute a non-gift loan under Treasury Regulations Section 25.2511-1(g)(1) as discussed above.

Fiduciary Considerations

Unlike a traditional loan bearing interest at a fair market rate, establishment of an interest-free loan requires the trustee to deliberate with respect to the appropriateness of the arrangement and the purposes for which trust income or principal is payable to the beneficiary while balancing the advantages and disadvantages among the current beneficiaries and remainder beneficiaries. The interest-free loan arrangement must be properly documented in writing and evidenced by a promissory note with an effective date and maturity to ensure that its treatment as a loan is respected and is not otherwise considered a trust distribution.

The trustee should also make sure to observe the terms of the trust agreement and its fiduciary duties and responsibilities when contemplating interest free loans to beneficiaries. These state law and governing document duties and responsibilities generally require the trustee to administer the trust property in a prudent and impartial manner. Some trust instruments may have specific provisions authorizing interest-free loans. As a result of fiduciary constraints, interest-free promissory notes may include terms that differ from traditional loans, including: (1) relatively short-term periods that provide the trustee an opportunity to review and make frequent independent decisions regarding the arrangement, (2) penalty provisions to ensure compliance, (3) provisions that convert the arrangement to an interest-bearing note in certain circumstances, and (4) provisions that provide for maturity of the note on the death of the beneficiary or certain other beneficiary-related circumstances. The trustee should be careful to ensure that the special terms of an interest-free loan arrangement comply with governing law and satisfy the beneficial interest requirements of the trust instrument.

Reporting/Compliance

The reporting of an interest-free loan arrangement requires special attention. As described above, an appropriate interest-free loan between a trustee and a trust beneficiary shouldn't result in taxable income, and no income reporting should be required if the arrangement falls outside the application of Section 7872 and

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the OID rules. Conservative taxpayers may avoid the risk of potential tax penalties by disclosing the nature of the transaction on Form 8275-R. Trustees should also consider state and local tax compliance rules since they may differ from state by state. Finally, the trustee should disclose the loan to the trust beneficiaries on fiduciary accounting reports and statements in accordance with the governing trust instrument and applicable law.

Concluding Remarks

Inflation and the corresponding sharp rise in interest rates has significantly altered the burdens associated with traditional intra-family loan structures. These market developments have a substantial impact on existing structures and new transactions which may cause clients and their advisors to review and consider alternatives. In the right circumstances, the trustee to beneficiary interest-free loan may be an ideal solution that promotes family harmony while appropriately balancing stewardship obligations with beneficiary needs.

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