Low-Interest Loans to Grantor Trusts

Overview of the Transaction

A low-interest loan, which is a loan at an interest rate equal to the AFR, to an IDGT is one of the simplest estate planning techniques available, and its ability to transfer wealth to descendants is similar to that of a GRAT or sale to an IDGT. Generally, the lender loans money to the IDGT in return for an installment note that bears interest at the AFR in effect for the period represented by the loan, compounded semiannually. See IRC § 7872(f)(2)(A). The borrower (the IDGT) uses the funds to purchase an asset. The amount by which the borrower's rate of return on the funds loaned to the trust (or on the asset purchased by the trust with the funds) exceeds the interest rate on the note is, in effect, a gift tax-free transfer to the borrower.

> **Planning Point:** A sale to an IDGT is preferable to a loan where the client has an appreciating asset that he or she wants to remove from his or her estate by transferring it to an irrevocable trust. A loan to an IDGT, which has comparable results to a sale to an IDGT, is preferable where the client does not currently own the appreciating asset but is planning to acquire such an asset. In that case, the client lends the purchase price to the trustee of the IDGT, and the trust purchases the asset.

Ideally, the note will be structured as a balloon note, where repayment of the principal is deferred until the end of the note term. Therefore, the borrower will make only annual interest payments to the lender. By using a balloon note, a larger percentage of the assets remain in the trust during the note term, thereby allowing the greatest compounding of appreciation inside the trust.

> **EXAMPLE:** Father lends $2,000,000 in cash to a grantor trust for the benefit of his children in exchange for a 5-year note with interest at the mid-term AFR of 4.65%. The annual interest payment will be $93,000. The trust uses the funds to purchase an appreciating asset. If the return on the investment of the asset is 10%, then at the end of 5 years, after the repayment of the $2,000,000 loan, the trust will have $653,246, which will pass estate tax-free and gift tax-free to the trust beneficiaries.

Estate Tax Consequences

If the lender dies with the note outstanding, the note will be included in the lender's gross estate. Depending on the interest rates prevailing at the time of the grantor's death, the value of the note may be more or less than the outstanding principal balance. If the AFR is higher than the interest rate on the note, the note will be worth less than the outstanding principal balance; but if the AFR is lower than the note's interest rate, the note may be worth more than the outstanding principal balance, thus reducing the benefit of the strategy. The risk that the note will be worth more than its face if the note's interest rate is higher than the prevailing interest rate can be reduced by having the note prepayable at any time by the borrower.

Gift Tax Consequences

The interest rate on the loan must be at least equal to the AFR in effect for the period represented by the loan, compounded semiannually, in order to avoid adverse income and gift tax consequences under IRC § 7872. See IRC § 7872(f)(2)(A). IRC § 7872 imputes interest in the case of below-market loans, which are loans where the stated interest is less than the AFR. Thus, if the stated interest on a loan to an IDGT is less than the appropriate AFR, the loan is subject to IRC § 7872.

IRC § 7872 recharacterizes a loan as a transaction in which the lender makes a loan to the borrower in exchange for a promissory note requiring interest to be paid at the AFR (rather than at the lower stated interest rate of the note). The deemed interest at the AFR in excess of the stated interest rate is called "imputed interest." Imputed interest generally is includable as taxable income to the lender. When loans are made to a grantor trust as to the lender, however, the imputed interest is not taxable interest to the lender.

The lender then is deemed to make a gift to the borrower (which the borrower is presumed to use to pay the imputed interest to the lender). The amount of the gift is equal to the amount loaned less the present value of the note determined using the AFR as the discount rate.

> **EXAMPLE:** Father makes an interest-free $1,000,000 loan to a grantor trust for 10 years. The AFR is 8%, compounded semiannually. The present value of $1,000,000 payable in 10 years at 8% interest compounded semiannually is $456,387. The amount of the deemed gift is $543,613 ($1,000,000 - $456,387).

If the aggregate outstanding loans (both market and below-market) between the lender and borrower are $100,000 or less, the imputed interest is limited to the borrower's net investment income for the year. IRC § 7872(d)(1). Whether the aggregate outstanding loans between the lender and borrower are $100,000 or less, however, does not limit the amount of the gift to the borrower.

If accrued interest payable on the loan is waived, canceled, or forgiven by the lender, such interest is treated as if it were paid to the lender and then re-transferred by the lender to the borrower resulting in a taxable gift by the lender. Prop. Reg. § 1.7872-11(a).

Income Tax Consequences

Because the loan is made to a grantor trust as to the lender, the lender does not recognize interest income. That is, for income tax purposes, the loan is treated as between the lender and himself or herself.

The trust will cease to be a grantor trust upon the grantor's death. Pre-death accrued and unpaid interest should not be taxable income to the grantor or the grantor's estate. In order to avoid the taxable income issues when the lender dies, the trust should pay all accrued interest or pay off the outstanding indebtedness prior to the lender's death. The trust could pay the note in kind with appreciated assets. Because the trust is a grantor trust, no gain or loss would be recognized on the payment, and the appreciated property used to pay the note would be included in the lender's gross estate and, therefore, would get a step-up in basis at the lender's death, thereby eliminating the capital gain.