Consider an intrafamily loan to cover estate taxes

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Sometimes estates that are large enough for estate taxes to be a concern are asset rich but cash poor, without the liquidity needed to pay those taxes. An intrafamily loan is one option. While a life insurance policy can be used to cover taxes and other estate expenses, a benefit of using an intrafamily loan is that, if it's properly structured, the estate can deduct the full amount of interest upfront. Doing so reduces the estate's size and, thus, its estate tax liability.

Deducting the interest

An estate can deduct interest if it's a permitted expense under local probate law, actually and necessarily incurred in the administration of the estate, ascertainable with reasonable certainty, and will be paid. Under probate law in most jurisdictions, interest is a permitted expense. And, generally, interest on a loan used to avoid a forced sale or liquidation is considered "actually and necessarily incurred."

To ensure that interest is "ascertainable with reasonable certainty," the loan terms shouldn't allow prepayment and should provide that, in the event of default, all interest for the remainder of the loan's term will be accelerated. Without these provisions, the IRS or a court would likely conclude that future interest isn't ascertainable with reasonable certainty and would disallow the upfront deduction. Instead, the estate would deduct interest as it's accrued and recalculate its estate tax liability in future years.

The requirement that interest "will be paid" generally isn't an issue, unless there's some reason to believe that the estate won't be able to generate sufficient income to cover the interest payments.

Ensuring the loan is bona fide

For the interest to be deductible, the loan also must be bona fide. A loan from a bank or other financial institution shouldn't have any trouble meeting this standard.

But if the loan is from a related party, such as a family-controlled trust or corporation, the IRS may question whether the transaction is bona fide. So the parties should take steps to demonstrate that the transaction is a true loan.

Among other things, they should:

- Set a reasonable interest rate (based on current IRS rates);
- Execute a promissory note;
- Provide for collateral or other security to ensure the loan is repaid;
- Pay the interest payments in a timely manner; and
- Otherwise treat the loan as an arm's-length transaction.

It’s critical that the loan’s terms be reasonable and that the parties be able to demonstrate a “genuine intention to create a debt with a reasonable expectation of repayment.”

If you’re considering making an intrafamily loan, please contact us. We’d be pleased to answer any questions you may have.

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