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TAX
News Concerning Recent Tax Issues

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TAX PLANNING OPPORTUNITY

Dennis L. Cohen • 215.665.4154 • *dcohen@cozen.com*

The dramatic reduction in short-term interest rates and the dislocation in the bond market have combined to create the following investment/income tax savings/estate planning opportunity.

In general, IRS requires that family loans bear interest at an applicable federal rate ("AFR"). Because AFR's are based on the rates of U.S. Treasury securities (varying by duration), the AFR's are at or near unprecedented lows. Thus, the short-term AFR (i.e., loans of three years or less) for February is .60%, and the mid-term AFR (loans exceeding three years but not nine years) is 1.65%.

Many corporate bonds, including investment grade obligations, are currently selling with yields to maturity of 7%-8%, with high-yield obligations yielding even more. The spread between corporate credits and AFR's presents enticing arbitrage and tax savings opportunities which can be illustrated by the following example. (For the sake of simplicity, I have ignored transaction costs and assumed that the corporate credit in this example is purchased at par and is "money-good.")

EXAMPLE - Mother lends adult daughter $1 million for a six year term at an interest rate of 1.65% compounded annually. Daughter uses the funds to purchase a six year corporate note of Kansas City Southern Railroad having an 8% coupon. Each year, daughter earns $80,000 in interest income and pays mother $16,500 in interest. Assume that daughter's effective tax rate is 20% and that mother's is 35%. Note the following benefits.

1. The aggregate federal income tax savings of this approach is $9,525 per year.
2. Ignoring the impact of income taxes, mother will have shifted $63,500 per year out of her estate without gift tax consequences, or $381,000 over the life of the loan, a potential estate tax savings of more that $170,000.
3. From the daughter's perspective, there is a pre-tax arbitrage yield of 6.35%, courtesy of her mother and Uncle Sam.
4. If she wishes to do so, mother could return $13,000 of daughter's interest payment without gift tax. (If the loan were made by both mother and father, the entire $16,500 could be returned without gift tax.)

A few final comments. First, the income tax benefits of this technique will not be available on loans to children who have not attained age 18 or who are students between the ages of 19 to 23. Second, in trying to keep this simple, I have ignored factors such as transaction costs, credit quality, professional fees, etc. Third, AFR's are adjusted each month and will increase if and when yields rise on Treasury obligations.

Please contact one of the attorneys in our Tax Group or Trusts & Estates Group if you would like to explore this opportunity.

TAX GROUP

Dennis L. Cohen 215.665.4154
Richard J. Silpe 215.665.2704

TRUSTS & ESTATES GROUP

Raymond G. Console 856.910.5011
Virginia S. Miles 215.665.6952
Burton K. Stein 610.941.2349
Michael R. Stein 215.665.5579
Margaret Gallagher Thompson, *Chair* 215.665.6959