

Perspectives on Wealth Management

ISSUE IV

Intra-Family Loans: Common Hazards and 10 Steps to Avoid Them



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One would think providing loans to family members would be foolproof from an estate planning perspective: Parent loans the child cash or sells the child an asset, takes back a note at a low interest rate, and the child pays back the loan over time (or the parent forgives it). What could be simpler?

The reality, it turns out, is more complex. There are traps lurking even within this seemingly uncomplicated strategy, especially for parents tempted to structure the process themselves. Indeed, without the proper planning or diligence, intra-family loans can create problems for families ranging from strained relationships to unwelcome scrutiny from the IRS.

An Example

Consider the following example:

Jim and Karen Smith's son Kevin approaches them one day requesting a loan to help launch a restaurant business. They are happy to oblige, lending Kevin \$3 million as seed capital. The Smiths set up the loan so that Kevin will pay 1.00% simple interest annually, with a balloon payment of all outstanding interest and principal in nine years. Meanwhile, Jim and Karen's estate planning attorney

suggests in an e-mail that they forgive \$26,000 of their son's note payments every year as gifts under their annual exclusion. The Smiths make the loan.

But because Kevin's restaurant is slow getting off the ground, he makes only a fraction of his payments. As such, Jim and Karen forgive \$26,000 in notes each year as gifts (of the \$30,000 due) and make no demand for repayment when the restaurant continues to falter. Ultimately, the restaurant fails, and the parents claim the loan as bad debt on their tax return.

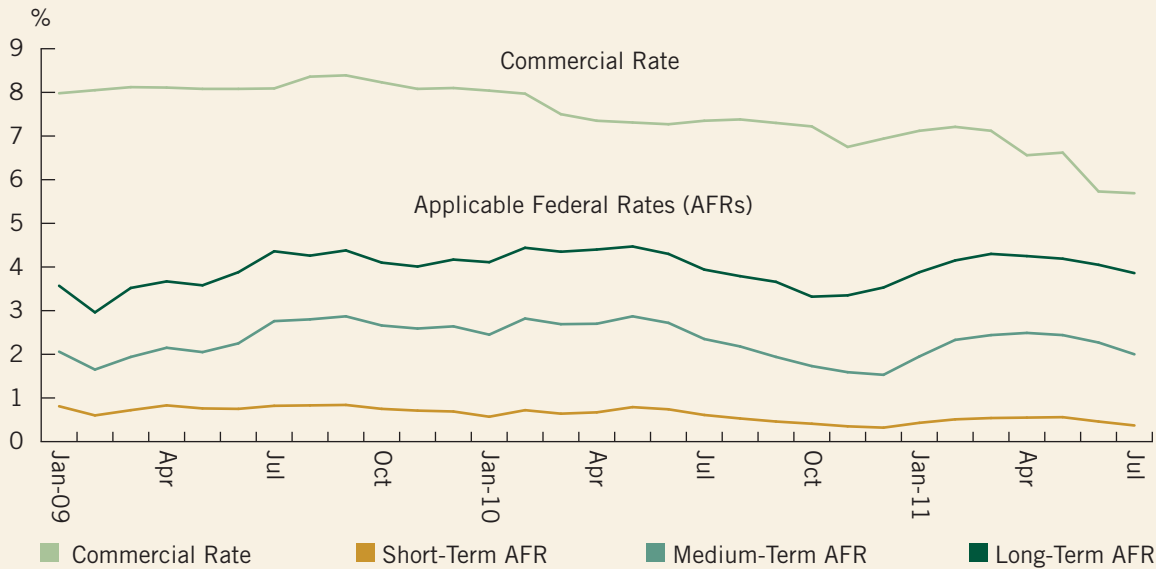
Anatomy of a Loan

In this example, Jim and Karen leave themselves vulnerable to IRS scrutiny and sanction, which they could have avoided by observing 10 crucial steps in setting up the intra-family loan. But before reviewing these recommendations, it's helpful to understand more about intra-family loan terms.

Attractive loan terms. If properly structured, intra-family loans let borrowers take advantage of interest rates lower than commercial rates, as the government allows related-party borrowers to pay a very low "safe harbor" interest rate. This Applicable Federal Rate (AFR), published monthly by the IRS, corresponds to the yields of Treasury bonds with corresponding maturities. Among its uses, the AFR sets the minimum interest rate that may be charged on an intra-family loan. In the example above, the annual percentage rate in July 2011 for Kevin's nine-year loan — the minimum annual rate that Jim and Karen could charge — was 2.00%.

This interest rate depends on the terms of the loan. For term loans of less than three years, the short-term rate

Exhibit 1: Intra-Family Loan Rates: A Bargain



Commercial Rate refers to the national average interest rate for \$100,000 FICO-based home equity loans. Source: Bankrate.com, IRS

(0.37% for July 2011) is used; for those from three to nine years, the mid-term rate (2.00%) is used; and for those longer than nine years, the long-term rate (3.86%) is used.¹

Simply put, the AFR is almost always lower than commercially available rates — and is now near historic lows. Commercial rates are typically much higher, even in today’s low-interest-rate environment (Exhibit 1). That means intra-family loan rates offer family borrowers a very attractive alternative to the loan terms they would receive from a bank.

Risk of setting rates too low. However, those who charge rates below this minimum “safe harbor” threshold could face unfortunate tax consequences.

Take the case of the Smiths again. Recall that Jim and Karen structured the loan to have a 1.00% interest rate — 100 basis points below the IRS minimum. In that instance, even if Kevin pays the 1.00% interest in a given year (\$30,000), he falls \$30,000 short of the minimum \$60,000 payment. To the IRS, this means Jim and Karen gave Kevin \$30,000 and received that amount back from him as income (in addition to the \$30,000 interest they received) (Exhibit 2). In other words, Jim and Karen incur two taxes: The first is a gift tax on the \$30,000, and the second is income

tax on the total interest income they are deemed to have received (\$60,000).

Is This a Bona Fide Loan?

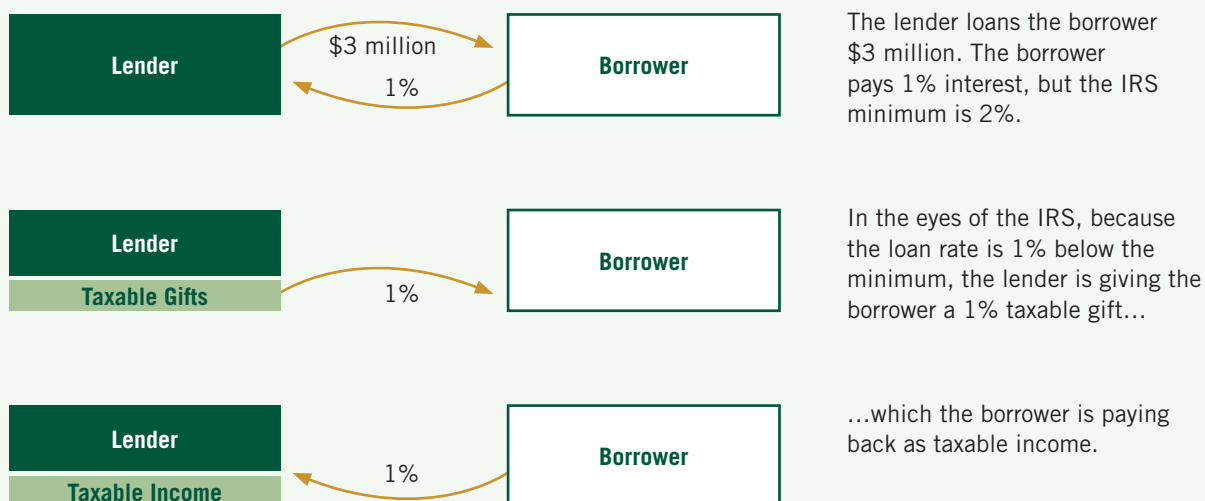
Unfortunately, setting the proper interest rate is but one of the hurdles. Perhaps a greater potential hazard for families is in properly administering the loan. Often the personal nature of the transaction causes family members to take shortcuts in enforcing the loan terms — something the IRS could jump on.

As a general rule, the IRS presumes that intra-family loans are, from the very beginning, actually disguised gifts. That places the burden on the lender to convince the agency otherwise. To do so, he or she needs to treat the loan — from beginning to end — as a bona fide business transaction, by showing there was a real expectation of repayment and an intention to enforce the debt when the loan was made. Those who, like Jim and Karen, show lenience in demanding full timely repayment, may not pass this test.

If the IRS finds that a family lender has periodically fallen prey to the temptation to forgive the note — a sure sign of disregard for the loan’s terms — they can re-characterize the entire loan as a gift to the borrower. The result is a much higher tax burden.

¹Demand loans, however, are trickier. The AFR for these loans — those for which the lender can demand repayment at any time — must adjust at least annually. The rate is also usually set to adjust to the short-term AFR every January and July during the time the loan is outstanding.

Exhibit 2: A Potential Double Tax on Intra-Family Loans



How, then, does a family convince the IRS that the loan was indeed made in good faith? They can do so by observing the following 10 steps, which have proved helpful in the courts for those seeking to overcome the IRS's presumption:

1. **Have the borrower sign a promissory note.** This is the single most important factor in the taxpayer's favor in proving the transaction was structured as a loan and not a gift. Like any other typical promissory note, this document should spell out the interest rate, the due date, and any payment schedule.
However, though this step is critical, it may not be sufficient on its own.
2. **Establish a fixed repayment schedule.** Doing this suggests that the lender expects to receive timely payments.
3. **Charge interest at or above the minimum "safe harbor" rate.** Lenders must know the proper rate to charge — and therefore the minimum the borrower must pay; ignorance is no defense. Use a term loan and a fixed rate, so that the interest is not adjustable and is easy to calculate.
4. **Request collateral from the borrower.** No respectable financier or bank would lend money without first demanding collateral from the borrower. For such a loan to pass the "business transaction" test, the lender should require that the borrower post collateral — anything from a home to a security interest in business assets. In the example, the fact that Jim and Karen asked Kevin for no collateral would signal to the IRS that the process was not nearly as rigorous as a typical creditor would demand.
5. **Demand repayment.** A family member who allows the borrower's payment due date to come and go without demanding repayment signifies he or she isn't serious about enforcing the loan's terms. Just as any reasonable business would pursue what it is owed, a family lender must do the same — or else the "loan" ceases to be one in the IRS's eyes and instead becomes a gift.
6. **Have records from both parties reflecting the debt.** In addition to a promissory note, both parties should maintain books reflecting the loan amount and regular payments.
7. **Show evidence that payments have been made.** All transactions should be fully documented, for instance, with a receipt or note acknowledging payment. Lenders should reflect interest income on their tax returns.
8. **Make sure that the borrower has the wherewithal to repay the loan.** If the IRS finds that one family member

lent money to another knowing he or she was already unable to pay off an existing debt, the lender will have a difficult time proving there was a reasonable expectation for repayment.

9. **Don't establish any plan to forgive payments as they come due.** A common method for making annual exclusion gifts to family members is for a relative to make a loan and forgive note payments as they come due (as Jim and Karen did). While this practice is widespread, it's not necessarily safe: The IRS will confront such a transaction when the facts are stacked in its favor. Outlining in writing a plan to forgive payments as they come due — as the Smiths's attorney did via e-mail — suggests that any debt obligation was illusory.

While some cases have allowed the annual exclusion (\$13,000 in 2011, \$26,000 for married couples) to apply to each annually forgiven payment, others have found this to be strong evidence that the lender never intended to be repaid. The key to avoid having the entire loan characterized as a gift is to avoid any implication that there was a prearranged plan to forgive the loan to avoid gift tax.

10. **Refinance with caution.** When, during a period of falling interest rates, the two parties exchange the initial note for one with a lower interest rate, the IRS might consider this a gift. That's because, from an economic standpoint, the parent has essentially made a gift by trading for a less valuable asset. Most practitioners believe, however, that refinancing is permissible for loans that allow prepayment. Regardless, an easy way to bypass this issue and safeguard against a potential IRS accusation is to renegotiate the terms of the note to compensate the parent for the lower interest. This could include paying down the principal amount, shortening the maturity date, or adding more attractive collateral.

Caveats

An additional and potentially overlooked consequence of intra-family loans is their impact on family relationships. On the one hand, transactions between family members

can benefit from a level of communication and mutual understanding that wouldn't be possible in a traditional debtor-creditor relationship. However, this can backfire as well; disagreements over loan terms or each party's responsibilities can strain family dynamics and foster ill-will. These loans can kindle resentment among relatives who do not receive loans, or who feel the lender is favoring a particular family member.

For instance, in our example, Kevin's sister may cry foul if her parents choose not to give her an equal \$3 million loan after Kevin defaulted on his. That's why parents should always be aware that their children pay attention to the nuances of loans to their siblings — how much they borrow, how much they pay back, and how they are treated throughout. As such, when it comes to intra-family loans, those who lend money to their relatives should communicate with all those potentially affected — not just the borrower.

Conclusion

Intra-family loans (including seller-financing for sales of assets to a trust for the benefit of descendants) are very attractive now, given today's extremely low interest rates and depressed asset values. For children or grandchildren with some wherewithal, the chances are good that they will be able to make a return on assets that exceed any interest they owe a family lender.

However, as our example illustrates, even the simplest loan transaction demands attention to administration and tax compliance. Moreover, the lender must be prepared to enforce the loan and deal with the fallout if plans go awry. If the potential borrower does not have the wherewithal to repay a loan, would-be lenders should instead consider straightforward gifts in light of the \$5 million increased gift tax exemption for 2011 and 2012. While not as efficient from a tax perspective, a direct gift carries none of the potential heartache and audit sorrow of a poorly planned or executed intra-family loan.

Taking Control of Your Credit Score Can Pay



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Communications Analyst

Ms. Hopkins is responsible for Bessemer's Next Generation client education initiatives.

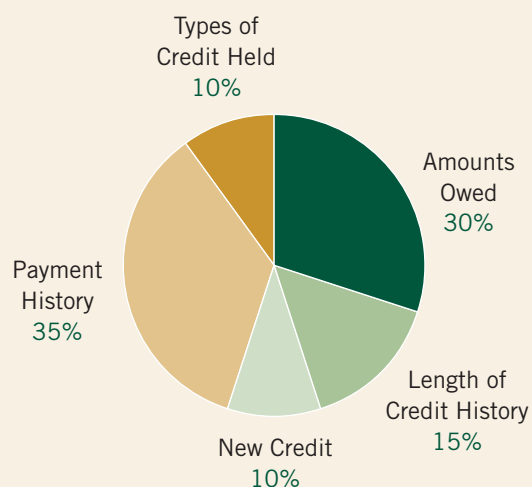
Most of our next generation clients know that having a good credit score is a positive thing. But we have found that many of them — particularly those in their 20s and 30s — assume their credit scores are strong because they own significant assets, have considerable money in the bank or in trust, or hold a steady, high-paying job. They are often shocked to learn that none of these factors impact their credit scores. That's why each year we devote part of our Next Generation Workshop to a discussion of the components of a credit score and the value that a good credit score can bring. It is a popular part of the curriculum that we felt was worth sharing in this edition for our younger clients who could not make it to the event.

A credit score, sometimes called a FICO score, is the result of a mathematical calculation of several factors, as illustrated in Exhibit 3. The score is essentially a ranking that compares one consumer's score to the scores of other consumers with similar profiles. It is an estimate of their ability to repay a loan or the likelihood of making payments on time.

Credit scores can range from 300 to 850. Since the recession struck several years ago, the definition of a "good" credit score has shifted upward as access to credit has tightened. Today a good score is above 700, and an excellent score is over 760. Any score below 560 is considered poor.

In the U.S., each of the three credit bureaus — Equifax, Experian, and TransUnion — calculate a consumer's credit score. Consumers are entitled to a free copy of their credit reports every 12 months. Credit reports are available through www.annualcreditreport.com, a site sponsored by the three credit reporting agencies. We encourage our younger clients to obtain their scores and work to get them as high as possible by taking the following actions:

Exhibit 3: Factors in Determining Credit Scores



Source: Fair Isaac Corp

- **Sign up for a credit card if you don't have one.** You may not think you need one, but this will help you build or improve your payment and credit history.
- **Use your credit cards lightly.** Rating agencies give higher scores to consumers who use only 10–30% of their available credit on a monthly basis. Request a change in your credit limit if needed.
- **Pay off your bills and credit card balances on time and in full each month.** Late payments and collections have a severely negative impact on credit scores. Setting up automatic bill-pay services with your bank can help ensure payments are made on time and accurately.
- **Take out an installment loan.** The use of personal, auto, mortgage, or student loans — in which you pay off a fixed amount every month — shows lenders that you can be responsible with various types of credit.
- **Use an older credit card from time to time.** The longer your credit history, the better. Think twice about closing an old credit card account, since it may bring down the average account length.
- **Monitor your credit history and score.** Review your score annually and dispute inaccurate or unfair claims on your

report by contacting the rating agencies directly. Individual credit scores must be purchased from the reporting agencies.

A Good Score Pays Off

Maintaining a good credit score can save money, especially over the long term. When taking out a mortgage to purchase a home, a borrower with better credit will receive a lower monthly interest rate and pay less than someone with poor credit (Exhibit 2).

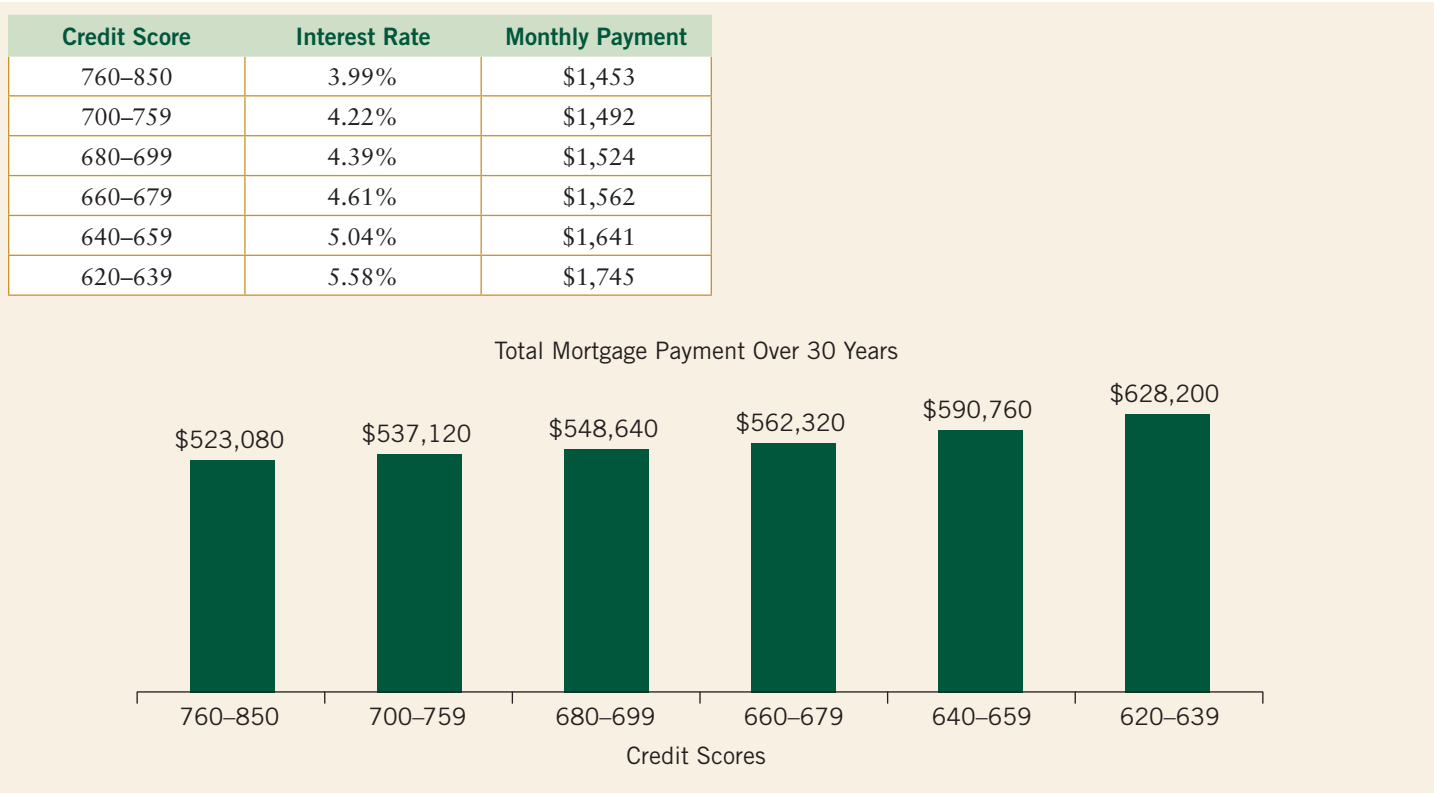
Let’s examine the impact of credit scores on a 30-year fixed mortgage. Two would-be homeowners — Kim and Steve — find homes in Chicago for approximately \$380,000, the recent average list price of homes in the area. Kim’s credit score is an excellent 762, and Steve’s is a middling 645. As one would expect, Kim receives a much better interest rate of 3.99% on a 30-year fixed mortgage, while Steve receives 5.04%. Because of this higher interest rate, Steve will pay almost \$68,000 more than Kim over the lifetime of their mortgages.

Good credit scores affect more than just bank loans. The rating agencies report consumers’ credit scores to other interested parties for an ever-growing list of reasons:

- **Job offers.** In addition to verifying experience and references, many employers check prospective employees’ credit scores before offering a job.
- **Insurance.** Insurance companies consider applicants’ credit scores to determine their likelihood to file claims, which can affect automobile and property coverage — and if so, at what rates.
- **Property rentals.** With rental markets heating up, landlords will pay extra attention to potential renters with good credit. It could be the determining factor in multiple-applicant situations or could perhaps reduce up-front costs such as the security deposit.

Building and maintaining good credit pays off regardless of your income and asset levels. Bessemer can help you or a family member examine your credit score and suggest methods to make improvements if needed.

Exhibit 4: Higher Credit Scores Yield Lower Mortgage Payments



Calculations based on 30-year fixed mortgage for \$304,531 loan, which represents \$380,664 (the average list price of homes in Chicago, IL as of the week ending July 27, 2011) less 20% down payment. Interest rates represented are Illinois state average as of August 3, 2011. Sources: trulia.com, myfico.com

Protecting Your Privacy



Patrick Darcy
Information Security Officer

Mr. Darcy develops and implements Bessemer's policies and procedures to protect clients' confidential information.

The staggering pace of technological change has brought forth new products and services that were once considered to exist only in the realm of science fiction. Unfortunately, with greater technological convenience come significant challenges related to privacy and information security. We outline below the many different steps Bessemer Trust takes to safeguard clients' privacy and confidential information, as well as offer several suggestions for how clients can help protect themselves.

Protecting Corporate Data

Bessemer has established and maintains security- and privacy-related policies and procedures designed to ensure that our information technology environment is properly managed and protected. All of our technology infrastructure is configured and secured according to industry best practices. Some of the specific measures we take to safeguard important data include the following:

Limiting access. Access to client data is restricted to those individuals who require it in the course of their duties. In order to access our network from outside Bessemer's offices, both employees and clients must utilize multi-factor authentication; a simple user ID and password are not sufficient. In addition, we restrict access to removable media (e.g., flash drives, DVDs, and CD-RW drives) and do not permit the use of WiFi (wireless Internet) at any of our offices. Any unknown computer is prevented from connecting to our network, and our connections to the public Internet pass through at least two firewalls.

Encrypting and safeguarding key data. All data in transit from Bessemer to a trusted third party (e.g., technology vendors, other financial institutions) is encrypted, as is data on all company laptops and smartphones. For physical records, client and confidential documents that no longer need to be retained are shredded in a secure environment.

Regular training and preparation. We maintain an ongoing privacy awareness program for all of our employees to keep them abreast of the latest developments in the field. Additionally, we have established incident-response procedures to deal with specific security-related events.

Operational Security and Monitoring

On a day-to-day basis, we continuously protect clients' data and information in the following ways:

E-mail. We use "Secure Mail" (securemail.bessemer.com) to provide safe communication between Bessemer and clients. We also monitor and screen all outbound Bessemer e-mails for confidential information.

Software. We run anti-virus and anti-spyware software on all of our servers and computers, and block employee access to malware and other malicious websites through web content-filtering software. Moreover, we utilize software that restricts unwanted or unapproved programs from launching from our employees' computers. To keep all of our PCs and servers up to date, we maintain a rigorous process in which we regularly apply vendor security patches and software updates.

Website. On the client website, we do not accept securities trades or other instructions, and continually monitor it for unusual activity.

Independent Testing and Verification

Additionally, our controls are independently monitored and assessed. Each year we have a) our Internal Audit staff perform over 20 technology-related reviews, b) external consultants assess our security vulnerability and conduct penetration tests against our network, and c) external auditors review each of the controls noted above. We are also regularly reviewed by federal and state regulatory bodies for compliance with Federal Financial Institutions Examination Council information security guidelines.

What Clients Can Do

While all Bessemer employees are responsible for safeguarding clients' confidential information, there are several basic rules of thumb we recommend for anyone wishing to take additional steps to protect their own privacy.

Do's and Don'ts for Personal Information Security

Do

- Log in to a financial institution website from a known computer only (one at home, the office, or a friend's house).
- Be wary of using unsecured or free WiFi connections, such as those in hotels or cafes. Someone else using the same WiFi hotspot can “listen in” on what you are doing.
- Run a reputable anti-virus tool on your computer and keep it updated.
- Apply security updates and patches to your computer on a timely basis.
- Disable the “geolocation” feature on your phone before taking pictures. Most smartphones have a built-in device that identifies your location and essentially stamps it on the file of any pictures you take and post online. Anyone viewing these pictures can determine where you are — and where you aren't.
- Be mindful of anything you post online on social networking sites such as Facebook, Twitter, or LinkedIn. These are common sources of valuable information for identity thieves and social engineers.

Don't

- Log in to a financial institution website from a kiosk at a hotel or airport lounge.
- Share your user ID or passwords with other people, including advisors, attorneys, and other staff. If they require access to some of your information online, work with your financial institution to establish a unique account for them.
- Use the same user ID and passwords at different websites. While it is sometimes inconvenient to manage several passwords, doing so protects your information from potential hackers.
- Use easy-to-guess passwords. The most effective passwords combine letters, numbers, and characters to form codes that aren't intuitive to outsiders but can be easily remembered by their creators. (For instance, the phrase “Friends, Romans, Countrymen, lend me your ears” could be the inspiration for an excellent password: “F,R,C,lmye.”)
- Click on links within e-mails (especially those that take you to a login screen) unless you are certain of that e-mail's validity. When in doubt, open a new Internet browser window and type the web page address from scratch (or use a bookmark).
- Engage in phone calls from sources claiming to be banks and credit card companies seeking to verify information. Instead, hang up and call the number on the back of your credit card.
- Include any sensitive information in a regular e-mail. When in doubt, pick up the phone or use Bessemer's secure e-mail option.
- Store sensitive information (such as scanned versions of documents) in locations where others can have access to it (including e-mail accounts, websites, and removable media), unless these are encrypted and password-protected.

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