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Your Bottom Line

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Navigating a clear course toward your financial security.

Managing Intra-family Loans

Warren Mackensen

As a result of the economic slowdown and tight lending practices at banks, more people are turning to family members for loans. While these intra-family loans can be beneficial for both parties, the pros and cons of lending should be carefully weighed and any loan should be formally documented.

For borrowers, loans from family members can provide access to credit that may not be available at the corner bank, along with lower rates and easier repayment terms. Additionally, borrowers can avoid taking out a loan using funds set aside for retirement in their 401(k) plan, which will generally carry a higher interest rate and put a large hole in retirement savings. With today's low interest rates, lenders also can benefit by receiving a higher interest rate payment from a family member than they would earn by keeping their money in the bank.

Still, these loans are not risk-free. Lenders should carefully consider whether the borrower, most often an adult child, actually has the ability to repay the loan. Extending loans to children who are not adept at managing their finances may lead to a bigger financial problem down the road. Before making a loan, consider whether you can afford not to be paid back. If not, these loans carry a higher degree of risk for the lender because the lost principal and income can leave retirement savings and cash flow short. Before writing the check, consider the strain a default might place on family relationships.

When family members with the capacity to lend agree to loan to responsible borrowers, they should formalize the transaction much like a bank would. Documentation helps both parties by making it easier to comply with IRS rules regarding income and gift taxes. Without documentation, loans may be treated as gifts, requiring the filing of a gift tax return if the amount exceeds the $13,000 annual exclusion amount. If a loan is made for a home purchase, borrowers can deduct the interest payments made as long as the debt has been officially recorded with the county clerk. For all loans, the interest income received must be reported on the lenders' tax return.

Payment terms on intra-family loans can be very flexible, but be careful about setting a very low interest rate. The IRS requires that lenders charge a minimum rate of interest, known as the Applicable Federal Rate. Setting a below-market interest rate can leave lenders liable for income taxes on the interest not received.

Having loans properly documented can also help with estate settlement should the lender die before the loan has been repaid. Only if the loan has been formalized can the executor easily account for the debt to the estate.

For help with documenting and tracking intra-family loans, resources such as LendFriend (www.lendfriend.me) and LendingKarma (www.lendingkarma.com) are available online. ❖

NATC Launches New Banking Services

David A. Batchelder

Through our relationship with National Advisors Trust Company (NATC), we can now help you meet your banking needs through the Private Bank of National Advisors Trust. The Private Bank provides a full array of competitive banking products including checking, savings, money-market, and certificate of deposit accounts, as well as lending solutions from traditional mortgage products to a securities-backed line of credit that provides cash access without disrupting your carefully constructed portfolio. With rates currently as low as 0.25% below the Prime Rate, these securities-backed loans can be an excellent alternative to personal loans, home equity credit lines, or borrowing from your brokerage account on margin. For more information, please contact our office. ❖

Brokerages Set to Provide Additional Reporting to IRS

Starting this year, brokerage firms will be required to report cost basis to the IRS on stocks purchased after January 1. While many brokerage firms already provided this information to taxpayers on their annual Form 1099 statements, only sales proceeds figures, not cost basis, were shared with the IRS. The new law is designed to improve tax compliance by making it much easier for taxpayers to correctly report their gains and losses.

For much of 2010, we have been working diligently with our custodians to ensure that they have the correct cost basis information for your accounts. As a result of this effort, the cost basis information that we maintain in our portfolio accounting system has been synchronized with the information on the custodians' books so that the basis we report on your tax return will match what the custodian reports to the IRS.

While the new rule applies only to new stock purchases in 2011, custodians will start reporting cost basis for mutual funds and ETFs in 2012 and individual bonds in 2013.

Going forward, when trades are placed in your account, your trade confirmation may include a notice regarding the new reporting requirements and requesting that you verify the cost basis method that will be used to calculate gains and losses. We have elected to use the "high cost" method of accounting for shares sold for all accounts. This approach will help minimize the current-year tax due on investment sales. There is nothing you need to do to verify your cost basis method on trades. ❖

David T. Mayes

Tax Law Update

With the passage of the 2010 Tax Relief Act, Congress and President Obama agreed to retain the Bush tax cuts, at least for now. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, income tax rates were set to rise from their 2010 levels of 10, 15, 25, 28, 33 and 35 percent. The new law extends these lower rates through December 31, 2012, just in time to spark heated debate during the next presidential election.

In addition to maintaining the lower brackets for ordinary income, the 2010 tax rates for qualified dividends and capital gains were also extended for two years. Qualified dividends and long-term capital gains will continue to be taxed at a maximum rate of 15% (0% for taxpayers in the 10 and 15 percent brackets).

The other major change impacting individual income taxes in the new law is the 2% reduction in the employee share of the Social Security payroll tax. Instead of the usual 6.2% withholding from workers' paychecks for Social Security, the rate for 2011 will be 4.2% on wages up to $106,800. Self-employed individuals will benefit from this tax cut as well, paying 10.4% on net self-employment income instead of the usual 12.4%. This tax benefit will partly offset the loss of the Making Work Pay credit which expired in 2010, and is expected to pump $110 billion into the U.S. economy in 2011. Unlike the Making Work Pay credit, the payroll tax reduction is not subject to income limits or phase-outs. An individual with wages at or above the Social Security wage base of $106,800 will see a tax benefit of $2,136 from the tax cut. The change will not affect the net pay of public employees and other workers who do not pay into Social Security.

Rules affecting Coverdell Education Savings Accounts, the American Opportunity Credit, and the child tax credit were also extended for another two years. The extension maintains the contribution limit for Coverdell accounts at $2,000 as well as the provision allowing these funds to be used for elementary and secondary school expenses in addition to college tuition and fees. The American Opportunity Credit, an enhanced version of the Hope education credit for college expenses that was passed as part of the 2009 Recovery Act, initially applied only for tax years 2009 and 2010. This credit will remain available through 2012. The child tax credit was slated to drop to $500 after 2010 but will remain at $1,000 for the next two years. ❖

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