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LB&C
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REAL ESTATE, TRUSTS & ESTATES, BUSINESS PRACTICE GROUPS ■ when it really matters

MAKING LOANS TO FAMILY MEMBERS

Part One of a Two Part Series

Deborah S. Barcham, J.D., L.L.M.

Parents and grandparents frequently make loans to family members to enable them to buy a home, start a business or enjoy some of the comforts of life. Since these loans are to family members they are often informal, undocumented and interest-free. However, serious tax consequences can result from familiy loans, and this two-part article will explain the income tax and gift tax effects and potential penalties which could occur if such loans are not properly structured, processed and administered.

The Loan May be Treated as Gift

If a grandparent makes an interest-free undocumented loan to a grandchild it is likely that the IRS will deem such loan to be a gift. If this should occur, the amount of the loan could unintentionally use up a portion of the grandparent's $1,000,000 lifetime gift tax unified credit, and if the unified credit has already been utilized the gift would be subject to gift tax. Therefore, it is essential to prepare a promissory note to document the loan to avoid the possibility of the loan being treated as a gift.

Loans with Little or No Interest

Even if a promissory note is prepared and signed, problems may occur if the note provides for no interest or insufficient interest. The tax consequences will depend on whether the note is a demand note (payable at any time the lender demands payment) or a term note (payable on a specific date).

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Demand Loans

If a grandparent makes an interest-free demand loan to a grandchild, the IRS will "impute" interest each year that the loan is unpaid. This means that Grandpa will be treated as if he charged grandson the appropriate rate of interest as determined by the Applicable Federal Rate (AFR) published by the IRS. (Each month the IRS publishes the AFR in effect for the following month, based on the term of the loan.) In addition, Grandpa would then be deemed to have gifted the interest back to grandson, which interest may be subject to gift tax.

For example, if on January 1st Grandpa loaned grandson $500,000 on an interest-free demand note, and if the AFR is 3% at the time of the loan, Grandpa will be treated as if he received $15,000 taxable interest for the year. Grandpa will also be treated as having gifted the $15,000 to grandson in that year, which may be subject to gift tax or may use part of Grandpa's $1,000,000 unified credit. This will continue every year the loan is unpaid.

When interest rates below the AFR are charged, the tax results are similar. If the interest rate charged was 1% and grandson paid $5,000 of interest on the $500,000 loan, Grandpa will still be required to report interest income in the amount of $15,000 ($5,000 actually received and $10,000 imputed interest). However, Grandpa will only be deemed to have made a gift of $10,000 of imputed interest to grandson.

Term Loan

When a term loan is made, the income tax consequences are the same as with a demand loan; however the gift tax consequences differ significantly. When Grandpa makes a $500,000 interest-free term loan to grandson, payable in ten years, there will be imputed income to Grandpa of $15,000 in year one assuming an AFR of 3%. However, instead of treating Grandpa as making a gift of the $15,000 imputed interest to grandson, since the loan is less than the AFR (in this example interest free), the IRS will treat Grandpa as if on the date of the loan he gifted to grandson all the imputed interest payments. This can constitute a very substantial up-front gift. Therefore, in order to prevent a large up-front gift it is essential that the term loan documents reflect the appropriate AFR.

Forgiveness of Family Loans

Often with family loans the lender will wish each year to forgive a portion of the loan using his or her $11,000 annual exclusion from the gift tax. The forgiveness of such loans presents a problem because the IRS often attempts to re-characterize loans with annual forgiveness as upfront gifts, arguing that such forgiveness indicates that the lender had no real intention of actually having the original note repaid. This argument has not been entirely successful due to the fact that the lender can change his mind at any time and choose not to forgive any additional portions of the note.

In order to withstand the IRS' forgiveness argument, whenever a portion of the loan is to be forgiven, the lender should write a letter to the debtor specifically stating the amount to be forgiven and what portion constitutes interest and what portion principal. Additionally, the lender should state that it is not his plan to forgive any portion of the loan each year, that he is making a gift of only the amount specified and is uncertain whether he will forgive any portion in the future. Similarly, if the term of a loan has expired the lender and debtor should execute a new promissory note with the appropriate interest rate determined under the AFR. ■

THE ABC'S OF FAMILY LIMITED PARTNERSHIPS

Deborah S. Barcham, J.D., L.L.M.

A family limited partnership ("FLP") is a business arrangement for family members where all of the family members are not equal partners. In a limited partnership there are two types of partners, namely, general partners and limited partners. The general partners possess full management and control of the business while the limited partners have little input concerning the operation of the company.

A family limited partnership (FLP) will have a written partnership agreement which will set forth the terms and obligations of the partners in accordance with the family's overall objectives and concerns. Under family partnership rules, the "family business" can include businesses composed primarily or entirely of real estate or investments in marketable securities.

How is a FLP Created and Structured?

In New York a FLP is formed by filing a Certificate of Limited Partnership with the Secretary of State. There are two types of partners, general partners and limited partners. While the general partners have full control over the operation of the FLP, the downside is that general partners are subject to personal liability for the obligations of the partnership. On the other hand, while the limited partners have no control over the management and affairs of the FLP they also have no personal liability for its debts and obligations.

Typically, the general partnership interests are held by the parents or grandparents, while the limited partnership interests are held by the children, grandchildren and/or trusts for their benefit. In many cases the general partners, the parents or grandparents, may own a 2% general partnership interest and initially own the bulk of the limited partnership interests, perhaps 96%, with the remaining 2% being owned by the children or grandchildren. In this example the parents' or grandparents' 96% limited partnership interest would then be available for purposes of effecting gifts to the children and grandchildren.

Upon formation of the FLP, family members make a contribution to the FLP as payment for their partnership interest. To accomplish this it is common for the parents or grandparents to make a cash gift to their children or grandchildren, who utilize the gift to make their contribution to the FLP for their initial limited partnership, even if only in a nominal amount. However, once the FLP is established the parents or grandparents can then gift all or a portion of their limited partnership interests to the children and/or grandchildren, thereby transferring interests in the company without relinquishing control.

A partnership agreement must be prepared and executed by all the partners setting forth in detail (i) the manner in which the FLP is to be managed, (ii) how profits, losses and cash flow are to be distributed, and (iii) the restrictions on transferability including when a partner may transfer his interest in the FLP, to whom, for what price and on what terms.

Estate Tax Savings – The Benefits of Leverage

The estate tax benefits of gifting limited partnership interests to children and grandchildren is that neither the partnership interest transferred nor the income or appreciation thereon will be included in the taxable estate of the parent. It is an excellent method of transferred valuable business interests to children and grandchildren without diluting control.

In many cases the gifts to children and grandchildren will have a value of $11,000 or less, which is the present annual gift tax exclusion. The annual gift tax exclusion will increase to $12,000 in 2006. Using the annual gift tax exclusion for gifts, especially if there are more than a few family members to whom such gifts are made, can result in significant estate tax savings on the death of the parents, especially if such gifts are continued over a lengthy period of years. Of course, gifts may be made in excess of $11,000 annually to any one person, but that would reduce the donor's unified credit, or if in excess thereof result in gift taxes.

Gifts to children and grandchildren may be leveraged by considering discounts for lack of marketability and lack of control. For example, a parent may be able to discount the value of a gift by 30%, more or less, depending on the nature of the business and the terms of the partnership agreement. For example, a gift of an interest in the partnership of $15,500 if discounted at 30% will have a value of $10,850 (less than $11,000) for gift tax purposes, and thus qualify for the annual gift tax exclusion. To determine the value of the partnership interest and the appropriate discount, a business valuation should be obtained.

In order for a discount to be valid and the FLP to be recognized as a business, there must be a legitimate business reason for the FLP. While there are several legitimate business reasons to set up and operate a FLP, including maintaining the business in the family, creating an FLP solely to avoid taxes is not a legitimate business purpose!

A FLP can also result in income tax savings. By shifting income to children the total family taxes may be reduced. However, if the income is unearned and the child is under age 14, the "kiddie tax" rules will apply and the

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THE LATEST . . .

What's happening here at LBC&C.

- Jane M. Myers, has been elected to the Board of Directors of ACIT (Advancement for Commerce, Industry & Technology.
- Marian Rice recently spoke at the NYC Bar's 2nd Annual Law Practice Mgmt Symposium

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child will be taxed at the parents' rate. Minor children can be partners in a FLP, but their interest must be held in a trust.

FLPs Holding Securities and Real Estate

Investment partnerships are partnerships that hold nonbusiness assets such as securities and real estate. An FLP can be based on these assets; however, in some cases, the arrangement may be considered an investment company, and in such case gains and losses will be realized on the transfer of the property to the partnership. Therefore, it is important to consult tax counsel on this issue. Normally, under partnership rules, gains and losses are not realized when property is transferred to the partnership.

Using a FLP for Business Succession Planning

A FLP can achieve many goals when used by a parent to transfer an interest in the business to children and other heirs. First, a parent can determine whether or not the child possesses suitable business capabilities by involving them in the business. Second, it is an effective estate planning tool by removing assets as well as the income and appreciation on such assets from the parent's estate, thereby reducing potential estate taxes. In addition, the parent can transfer the limited partnership interests in small increments over a period of many years, while the parents still control the FLP through ownership of the general partnership interests.

Are FLPs Still Viable Due to Recent Court Challenges?

The IRS has had some success in court challenges to FLPs. However, the success by the IRS has come in those cases where the partners have failed to adhere to the following important rules: (i) all income distributions must be made on a pro rata basis to each partner and distributions should be made at least once annually; (ii) the FLP must be properly formed and maintained with an appropriate partnership agreement and must be treated as a regular business entity; (iii) all assets of the FLP should be titled in the name of the partnership on transfer to the partnership; and (iv) the partnership should not pay the personal bills or expenses of any partner.

FLPs are recognized and commonly used for family business purposes. However, the rules are more complex than those briefly stated above and a knowledgeable attorney should be consulted with respect thereto. ■

WHAT TO ASK FOR IN A COMMERCIAL LEASE

Jane M. Myers, Esq.

"If you don't ask, you don't get". Ignoring this familiar phrase can come with a hefty price tag for a tenant when negotiating a commercial lease. However, asking for what you want is the second step. The first step is knowing what to ask for.

In the typical review and negotiation of a commercial lease, the tenant's attorney may raise a concern or two usually not mentioned in the lease, but typically the lawyer responds only to what the lease already says. A savvy tenant's attorney knows that a landlord's "standard" lease does not address many issues beneficial to a tenant.

In a situation where almost anything can happen, the goal for the tenant is to be aware of potential issues that could arise when two parties with different agendas concerning the same piece of property negotiate a lease. Although the tenant may have a good working relationship with the current landlord, the building may be sold in the future and the relationship with the new landlord may not be that wonderful. Therefore, it is critical that the lease protect the tenant.

A Tenant Should Keep These Issues in Mind: Agreement on the Basic Terms

As early in the negotiation process as possible, obtain a term sheet from the landlord that describes the basic terms of the transaction. Make sure that the landlord and tenant have the same idea as to the basic terms of the deal. This is the opportune time (while it is relatively easy and inexpensive) to raise and resolve significant issues, such as the availability of tax incentives, rebates, the selection and coordination of tenant's professional team (architects, construction team, financial advisors and lenders), whether present occupancy of the premises by an existing tenant will delay the new tenant's move-in date and whether the new tenant's intended use requires special permits (e.g. liquor license or public assembly permit).

Building Out the Space.

Once the lease is prepared, pay attention to clauses covering Tenant Alterations to the premises. Make sure the tenant is not required to obtain the landlord's consent for decorative or minor alterations or the erection or demolition of partition walls. If landlord has approval rights for substantial construction (and they generally do) attach to the lease a list of landlord approved contractors and require the landlord to be reasonable if consent is required for alterations. If there are outstanding violations that may interfere with the tenant's proposed alterations, make it a condition of the lease that the landlord cure the violations within a specific time frame. A huge costs savings measure that is often overlooked by the tenant is to include a provision that tenant is not required to restore the premises to its original condition if it is generally usable by other tenants.

Tenant's Control

The landlord will typically reserve the right to enter the premises. To control potential interference with tenant's business, the lease should provide that tenant receive sufficient prior notice, designate those circumstances when landlord can enter (e.g. to make emergency repairs or to show the premises to prospective tenants or buyers of the building) and specify when and to whom access will be given. It is important to provide language that requires the landlord to minimize interference with tenant's business and to comply with tenant's instructions and security requirements. The tenant should consider prohibiting landlord's access to certain areas, such as computer network control rooms or areas containing a vault.

Other Tenant Protections

In New York, there is no legal requirement for a landlord to mitigate damages if a tenant defaults. This means if the tenant stops paying rent, and unless the lease states that the landlord must actively pursue finding a substitute tenant, the landlord can sit back, look to the defaulting tenant for the rent and will not be penalized for not seeking a new tenant. The tenant should insist that the lease require the landlord to re-let the premises. Another tenant protection is to exclude the landlord from termination of the lease or evicting the tenant due to "non-monetary" defaults. Instead, require the landlord to convert any "non-monetary" default into a monetary default by curing it and then sending the tenant the bill. In the event of destruction of the premises by fire or other casualty, negotiate for the tenant's right to terminate the lease if the casualty or restoration causes a material change in zoning, access to the premises, parking or visibility of the premises. At the very least, make sure rent is abated during restoration.

By knowing what to ask for, a savvy tenant can save itself a substantial amount of money in a commercial lease negotiation. ■

THE BLACK & WHITE ON INDEPENDENT CONTRACTORS

Jane M. Myers, Esq.

Employers sometimes look to categorize certain types of help as "independent contractors" to avoid paying the high cost of employee benefits, taxes and potential workers' compensation claims. However, it is important to keep in mind that just because an employer treats someone as an "independent contractor" doesn't mean the IRS will agree.

The general rule is that a worker is an independent contractor if the employer has the right to control or direct only the result of the work and not the means and methods of accomplishing the result. This means an employer simply assigns the worker a task and pays the worker when the task is accomplished. However, the work arrangement is not that black and white. If the employer incorrectly characterizes a worker as an independent contractor and not an employee, the employer can be liable to the IRS for penalties, past employee benefits, employment withholdings, as well as legal fees to litigate the issue.

When determining a worker's work status, the Courts and the IRS look to the presence of a number of factors, as follows:

- employer's level of control over the worker, including hours, place and sequence of work performed
- whether the employer provides training and equipment
- how payment is made to the worker, and whether the worker's business and/or travel expenses are paid
- whether the employer requires the full-time services of the worker (this does not exempt part-time workers)
- whether the worker is employed by anyone else
- whether the employer hires, supervises and pays the worker's assistants
- whether the worker is required to submit written or regular reports
- whether the worker has invested in workplace facilities where work is performed
- whether the worker can suffer a loss or realize a profit as a result of work performed on employer's behalf
- whether a continuing relationship with the worker exists
- whether the worker can sever the relationship with the employer without incurring liability
- whether the worker can be fired for reasons other than failing to meet contract specifications
- whether or not there is a written agreement in place between employer and worker classifying the worker as either employee or independent contractor

The overriding determinative factor is the degree of employer control over the worker - the greater the control, the more likely the relationship will be deemed one of employer/employee.

It is critical for employers to carefully scrutinize the factors surrounding a worker's employment before making a decision to treat a worker as an independent contractor. Mistakes can be very expensive. ■

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