Protect yourself when lending money to family

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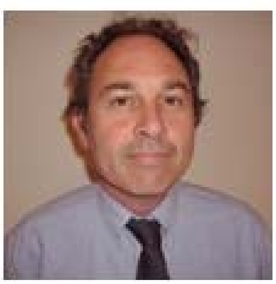

By ADAM COURTENAY

As tempting as it is, loaning money to family and friends is fraught with danger. The interest rate may be low, but emotional costs can be high. Getting the right documentation in place is the best protection.

At our most calm and logical, most of us would say that lending money to friends is rarely a great idea, and lending money to a family member is among the worst of ideas – but calmness and logic are not what most families are about.

In 2017, a court in Brisbane heard the case of a son who refused to repay the A$280,000 his aged parents loaned him over several years to keep his business running. He had taken loans from his parents 13 times between 2009 and 2013. Some were sums offered for personal reasons, and some were for his business. The problem was the parents could not prove they had legally enforceable loan agreements with him.

Murray Berghan said he'd accepted the money his parents, Barry and Lorraine – both in their 70s – offered him as a "gift" and not as a loan. If they had documented the loan – even in a simple way, it could have been enforceable.

Judge William Everson declared Berghan “cynically abused their generosity”. Even though he had declared in an email that he would pay back the money, it was no more than a moral obligation, not a binding loan agreement, the judge ruled.

Berghan’s parents appealed, and Judge Everson’s decision was set aside. In October 2017, the Court of Appeal ordered Berghan to repay his parents A$286,471, with interest.

> **“There needs to be a firm conversation among family members to mitigate any future disputes when dealing with family businesses.”**
> **Peter Docherty, CPA Australia**

The Berghan case may be extreme, but it does provide some lessons that many of us tend not to heed when lending money to family and friends. At the time, **Queensland Law Society** president Christine Smyth said this had been a case with warning bells attached; even if you’re lending to those closest and dearest to you, you should be seeking independent advice, Smyth warned.

This warning is echoed throughout the financial, legal and accountancy sectors.

“I tell clients not to give their kids anything,” says financial adviser Laura Menschik, director of **WLM Financial** services in Sydney. “However, if you feel you’d like to help them with a loan, that’s another matter,” she adds.

Menschik advises finance professionals to try and get into their client’s psyche to see exactly whether this is an emotional or a purely financial transaction.

“I would say that in most cases this should be a financial transaction to protect the lender and the borrower.”

Make invisible loans more solid

However, the loan-gifts keep coming, and very few of them are documented. A 2016 RMIT University report, *Lending to Family & Frien*ds *– an Invisible Phenomena*, says research in the US, UK and Australia suggests the value of these informal lending markets extends into the billions of dollars per year.

In its **2017 Asia-Pacific Small Business Survey**, CPA Australia found that funding from family and friends was somewhat popular as a source of finance for small business, particularly in New Zealand, where 12.4 per cent of small businesses that required external finance named it as their main source of finance.

In its ***2014 An Invisible Finance Sector*** brief, the US Financial Diaries study revealed that loans from family and friends were the second most common form of credit. Inter-personal loans, as they are described, rivalled traditional commercial loans in size.

A survey for CommBank Kaching in 2012 found that the average Australian borrowed more than A$200 from someone close to them nearly every month, and researchers estimated the informal lending market between families and friends was worth A$1.6 billion a year. Of course, most of these informal loans are invisible.

However, if the loans are as large and as frequent as some studies suggest, then this is an activity that has been woefully provided for in terms of financial, legal and **taxation** advice.

What do family and friends borrow money for, and when is it most problematic? In the experience of David Harland FCPA, managing director of family business advisory **FINH**, it's the loans to family members for businesses that cause the biggest problems. These tend to be handled with the least professionalism. Parents cannot scrutinise a prospective business in the same way as a professional, who would know that determining risk is part of the process.

Then there are the loan-gifts to buy property. Ramon Mitchell, director of acquisitions at **Performance Property Advisory** in Sydney, says that he's witnessed phenomenal growth in the family guarantee, which allows borrowers with little or no deposit to finance a property. In many of these cases, a borrower's parents are willing to provide a limited security guarantee secured against their home, an investment property or a sum – possibly a term deposit.

"I'd hate to see the total book of loans out for kids," he says. In Mitchell's experience, generations X and Y avoid pursuing a slow crawl up the property ladder and instead head directly for the most expensive suburbs, borrowing amounts much larger than the cushion extra parental help may provide. Herein lies the danger for parents.

"They're stepping up in purchase price, which keeps them close to maximum stress," Mitchell says.

What can be done? Tim Dean, founder of cloud-based loan documentation service **Credi**, believes a simple paperwork process, which keeps both parties on their toes, is the answer. The idea of going to a lawyer to draw up an agreement would not excite most parties, Dean says, and yet documentation will remove that uneasy conversation about last month's missing repayment. Dean's site has a loan-builder module which, he says, can do the complicated maths and present the loan in an easily digestible package.

"Some people deal in rates, while others say: 'I'll lend you A$100,000; you can repay me A$101,000 back in two years' time'. Others may want monthly repayments. The platform can handle all the different scenarios," says Dean.

Documentation is vital

Harland says education is a big part of the equation, which includes a family-wide policy on the provision of family capital, where “the expectations are clear and an education process occurs well in advance of the need”.

Irrespective of the size or amount of wealth, the principles should be the same and should clearly stipulate what’s eligible as a loan, for example, the purchase of a first home or funds for a new business venture. It goes without saying that a document clearly outlines the terms of the deal and offers a set repayment schedule.

There is, of course, the worst-case scenario. If you act as guarantor, be sure that the amount guaranteed is repayable. There could be boundless repercussions if you offer an unlimited guarantee, and that includes responsibility for any outstanding fees, charges and interest. An unpaid loan could also damage your credit record, affecting your eligibility for future finance. You could be made bankrupt and made to forfeit assets that weren’t even offered up as security in the first place.

Documentation should come in the form of a written application setting out the same tenets and principles as a loan offered in any ordinary commercial environment. “Who reviews and approves it? It could be that certain family members come together with an independent adviser, or a family ‘investment committee’ is set up,” Harland says.

Peter Docherty, general manager of public practice at **CPA Australia**, says intra-family disputes that stem from loans also need to be resolved early and made clear to all, with a weather eye on future disputes over wills.

"There needs to be a firm conversation among family members to **mitigate any future disputes** when dealing with family businesses," he says. Pre-payments of school fees, for example, may need to be made on the understanding that they form part of a future inheritance.

"It needs to be understood that some monies are part of an entitlement to a future estate – that is, the loan is coming off the final score," Docherty says.

"Every relationship is different but, in most cases, this is about putting in a safety net for everybody," says Menschik. "You make sure kids near a pool have their floaties on – it's the same thing for financial matters. Putting in protections is common sense."

What is a loan and what is a gift?

What constitutes a loan and what constitutes a gift is often barely recognised by either the lender or the borrower, and the definitions are not as clear-cut as you might think. It's often a case of: "Just take the money. We'll work something out later."

Loans and gifts sometimes feel similar, but they're treated differently in taxation and law. Say an adult son or daughter was married and the couple borrowed money from family to buy a property. If the relationship ends, and the money was a gift, it will be considered part of a couple's assets and assessed in the break-up.

If the money was a loan to one person in the couple, however, only that person is liable to repay the loan. That means a spouse walking away from a relationship may be free of that debt.

A gift is generally thought not to be taxable, but in some circumstances the **Australian Taxation Office** (ATO) may treat gifts as taxable income. If you get a car as a gift from your employer, and you use it for work purposes, the ATO may deem that car related to your job and subject to tax. However, if your father gives you a car for your birthday, it's unlikely to be taxed.

The important thing is that the gift should not have the characteristics of income. Regular payments to a family member or friend, for instance, might be construed as income, rather than a gift, and be treated as taxable income.

If you think the distinction is obvious, think again. Frances Edwards, principal of **Edwards Family Lawyers** in Sydney, says that as with most contentious issues in family law, the existence of a valid loan is always assessed on a case-by-case basis.

"While there is no exhaustive definition of what amounts to sufficient documenting of a loan, the existence of a loan agreement and/or a registered mortgage in favour of the family member loaning the money is persuasive in the actual existence of a loan, as opposed to a gift," she says.

Edwards says the credentials of any informal document, whether dated or not, will be scrutinised by the court.

It is only when a loan is appropriately documented with a loan agreement and secured with a private mortgage that a court would be most likely to see it as such. The debt that is subject to the loan then becomes a secured debt.

"This is perhaps the most sure-fire way to bolster its credibility and to ensure that the loan is taken into account on the balance sheet as a liability," Edwards says.

A history of regular repayments towards a loan, or the fact that substantial lump sum payments have been made to reduce a loan, is helpful in validating its existence. Loan repayments in the form of gifts or services are better avoided, as it can be difficult to quantify their value after the fact, and to verify that the transaction actually took place.

There is another important caveat to a loan. In New South Wales, there is a time limit of six years for any civil claim. In Vadisanis and Vadisanis and Anor [2014], the Family Court found the alleged loan was unenforceable because six years had expired since the date of the loan, and no demand had been made for payment.

SMSF loophole closed

There is another corollary to the family loan scenario that has been subject to new rules from the Australian Taxation Office (ATO). Self-managed super funds (SMSFs) can no longer benefit from cheap loans from family or related parties if they want to keep their favourable tax rates.

The ATO has progressively issued new guidelines because it was concerned some taxpayers may be using limited recourse borrowing arrangements (LRBAs) to circumvent **superannuation** contribution caps and allow more funds to enter the concessionally taxed super environment.

Imagine that a wealthy businesswoman has her family trust lending A$100 million to her SMSF to buy a city office tower. The family trust fully funds the loan and charges 0 per cent interest on the loan to the fund. The normal rate of interest in the commercial world may be around 5 or 6 per cent.

"If you did things this way, the fund would in essence be getting an automatic A$6 million benefit," says Bruce Brammall, a director of Melbourne-based advisory **Bruce Brammall Financial**. "This kind of arrangement is no longer possible," he says.

Brammall says the terms of loans that are made to SMSFs need to be made on a commercial basis – the rates charged must be comparable to what a bank would charge and the loan-to-value ratios should also be similar to a mortgage.

“If, for instance, there’s an interest-only period, it must be what lenders would normally offer – around five years. The length of the repayments must also be set commercially – that is, over the course of 25 or 30 years,” he says.

If a family loan does not follow these lines, the ATO may classify the income from the loan as “non-arm’s length income”. The income would then be subject to tax at the top marginal tax rate of 47 per cent, instead of the concessional income tax rate of 15 per cent that would normally apply to SMSF income.