

Making Loans and Gifts to Family Members

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Summary

Loans to family members can sometimes be of financial benefit to both parties. Gifts also can be a blessing to both giver and receiver. It is important, however, that everyone be clear which kind of transaction it is, and what the expectations should be.

Why be a lender or giver?

- You probably want to help out a child, a parent, or perhaps another relative, if you can. Children and other young relatives may be strapped for cash for quite legitimate reasons: college costs, home purchases, giving birth to or adopting a child, medical emergencies, job lay-offs, divorce, and so on. Conversely, a child may be eager to assist a parent or other elder relative who is struggling financially, or who has unexpected expenses for medical care, home repairs, or other needs.
- Lending is a form of investment. Suppose you earn 4% on your savings, and suppose your child pays 14% interest on a credit card balance he or she cannot afford to pay off. If you loaned enough money to your child to repay the debt, and charged 9% interest, you would get an extra 5% on your savings and your child would save 5% on the debt. You both win!
- If you are wealthy enough that your estate will be subject to federal estate taxes when you die, you can reduce that liability by giving away something while you are still alive. The government allows each person (i.e., both husband and wife, if married) to give up to \$13,000 a year* to as many individuals as they like, exempt from gift taxes. This allows you to pass assets to children or other relatives without Uncle Sam taking a bite. If you give certain kinds of assets (e.g., stocks that might appreciate in value, or life insurance) you could multiply the effect. An estate planning specialist can advise you whether gifts during your lifetime make tax sense in your situation.
- Your kids or other relatives are likely to end up with some of your money anyway. If you can afford to, why not get the joy of being a gift-giver during your lifetime?

Why not be a lender or giver?

- You may not be able to afford it. Only you can really determine that. Yes, you might have enough at present, and for some years to come, but only you can determine how much of a financial cushion you need so that you aren't awake nights worrying about it. If someone is trying to "guilt" you into making a gift or a loan, that person is the one who probably should feel guilty.
- Even a loan may be a loser for you. Sometimes family members don't feel comfortable charging interest to other family members. Or the interest rate may be low

* This amount is subject to occasional inflation adjustments. The \$13,000 limit went into effect on January 1, 2009 and remains at that level at least through 2012.

enough so that you are really losing money compared to what you would get from other savings and investments. In general, you should expect at least the going rate for money you lend; anything less is actually a gift. Furthermore, if you lend money for a down-payment on a house, the bank lending the mortgage may require you to sign a statement saying that the loan is actually a gift. This might make it harder for you to collect the loan back later, and it may even require you to pay gift taxes, if the amount is high enough.

- Family loans are usually not secure. Although, as explained below, even family loans should be formalized in a simple written agreement, it is rare that any collateral is provided. The only security for the loan is the good will of the borrower. And despite the good will, family members often take family loans lightly, and sometimes don't even expect to have to repay them or if they do expect to, they put them at the bottom of their priority list, so in fact it may never quite get done. If you lend to a family member, therefore, and especially if you make a loan without signing an agreement, you would be wise to assume you will never see your money again. And even if you do, it could be a long time coming. About 14% even of family loans with written agreements end up not being paid. So when deciding whether you can afford to make a loan, take into account that some or all of it might never come back to you.
- The person who needs the money may be irresponsible. He or she may be a loving, wonderful person in other ways, but some people simply cannot handle money. Giving or lending to them may not be the best thing for *them*. If they are really in a tight spot, you might find other ways to help instead. Perhaps it is better to let a child move back in with you for a while rather than having him or her keep trying, unsuccessfully, to live independently. Maybe it is better for you to be co-buyer of their new home, rather than lending or giving them the money to buy it themselves. Or if only cash will do, offer to pay bills directly rather than by providing money that might end up spent on something else. You can also attach strings, especially to a gift: perhaps you offer to help out financially only if the person goes to a credit counselor (or into rehab, or whatever they need). It's your money or you might be able to call the tune. But if that doesn't work, maybe you just shouldn't contribute any more.
- A loan or a gift might change the relationship between the parties. A lender or sometimes even a giver or can feel that he or she now has some say over how the recipient handles financial matters, even if that wasn't part of the original deal. Naturally, this leads to arguments and resentments. Conversely, the recipient may feel weak or dependent, maybe even guilty. With loans, treating the transaction as at least in part a business matter, with terms spelled out (and, ideally, interest being paid) can lessen the emotional dangers. But these are still pitfalls to be watched out for.

Being smart about the transaction

Whether your motives are entirely loving, or entirely financial, or somewhere in between, you can still be smart about what you do. Of course, if you have plenty of money to spare, and you have a fabulous, trusting relationship with your child or other person to whom you are providing funds, then perhaps it doesn't matter. Or if you are the receiver, and you know that the giver or lender can easily afford what is being offered, then there is less need for caution. The same applies if the dollar amount is small.

But in most cases, it is smart *ó* and not just for financial reasons *ó* to recognize that a large gift, or a loan of any but the smallest size, has a business element. By putting the terms in writing:

- Both parties have a clear understanding of what is happening. If your family conversations are like most, different ideas get kicked around. Eventually you come to an agreement. Or did you? How much was the final amount again? Was it being provided all at once, or over time? Is it a gift, a loan, or some of each? Is interest being paid *ó* and if so, how much and how often? Is part of the principal being repaid periodically, or is it due all at once, or is it open-ended? Putting it in writing will ensure that everyone knows what the arrangement really is.
- There is a record for the future. We not only misunderstand sometimes what one another really means, we also forget over time exactly what we agreed to. Having it in writing can save a lot of arguments down the road. Yes, sometimes borrowers even forget that they borrowed money at all! A written agreement protects everyone. And if it is a loan to be paid off, the agreement should be marked PAID and returned to the borrower when that happy day arrives.
- You have proof for others. You lend \$10,000 to your niece so she can start a business, but it's done on a handshake basis. Three years later you die, and your widow needs to start getting repaid on that loan. Does she even know about it? Does she remember? Does she have any proof that the transaction ever occurred? Or perhaps the niece dies, and her husband sells the business at a nice profit. Does he know about the \$10,000 loan? Does he care? He will if you have a signed agreement. The borrower is protected the same way. If the agreement says the loan is not repayable until the 10th year, then the borrower does not have to honor a demand by the lender or the lender's heirs that it be repaid sooner. This is especially true for gifts. If someone receives a gift, then the giver dies, the giver's heirs might (even through an honest mistake) demand repayment, thinking it was actually a loan *ó* how much grief is saved for everyone if the gift was made in writing! And of course, gifts made for estate planning purposes should always be documented. And yes, as explained below, the IRS could get involved at some point, too. Then you really will wish you had it in writing.

Some points of procedure

What about gifts to help pay for current or future college costs?

This is a more complicated subject, not covered in this paper.

Do you need a lawyer?

Usually not, for a simple one-time gift or loan. Just put the terms in writing, and have both parties sign it. A sample form for a loan (traditionally called a *ó*promissory note*ó*) appears at the end of this paper. Of course, having a lawyer involved is fine, and in fact it is recommended if there are any complexities involved (for example, if you are co-buying a home, or if collateral is being provided for a loan). If you are making a gift under the Uniform Gifts to Minors Act, or setting up a trust, of course, professional advice is a must.

If you receive interest on a family loan, is it tax-free?

No. Federal income taxes are due. Of course, the government probably won't find out about the loan, but the taxes are due anyway. If you get audited and they discover it, you are theoretically liable for tax fraud — same as Al Capone.

Furthermore, if you charge an artificially low rate of interest, the government may consider that you actually earned a higher rate (which they define), even though you never received the money, and you will have to pay back taxes on those amounts. But these rules about the size of the interest rate apply only to family loans above \$10,000 (or above \$100,000, if the recipient has \$1,000 or less in investment income).

If the loan is interest-free (or very low interest), and the borrower does not qualify under these \$10,000 or \$100,000 exceptions, you should also consider specifying in the loan document (promissory note) that the loan is payable on demand. If you don't, the IRS could calculate all the future interest payments you are waiving, and treat them as a one-time gift, putting you over the \$13,000 limit.

Is interest that is paid tax-deductible?

Maybe, depending on what it is used for. If the loan is for business use, interest is usually deductible as a business expense. If it is used for investment, or to purchase a home, it may be deductible in full or in part as investment or mortgage interest. Otherwise, it is generally not deductible under current law.

What if the borrower is not making payments on time?

Unless you intend to forgive the debt (at which point it becomes a gift, legally), you should remind the person to whom you loaned the money that payment is late. You don't have to be unpleasant about it, and you might suggest that the terms of the loan be modified if they turn out to be too strenuous — banks do this all the time. But to just let non-payment go unremarked is, in effect, to imply that it doesn't matter; if it persists, a legal argument can be made that the loan has in fact been forgiven and is no longer due. If that is your intention, it is better to do it openly, and get credit for being a great person. If it isn't, then you should work matters out directly, so that it doesn't become a permanent sore spot between you and someone who matters to you.

If the loan is defaulted on, and you itemize Federal tax deductions, you may be able to deduct the loss. You need written proof, though, that the loan was made and that you tried to collect on it. However, the IRS will probably look for the borrower to make good on the lost taxes, so don't do this unless you want to get the defaulting family member in dutch with the IRS.

What are the tax consequences of making a gift, or forgiving a loan?

A loan becomes a gift if it is forgiven. Gifts above the \$13,000/year Federal limit are theoretically taxable. In reality, this almost never has an immediate effect, except that you should fill out IRS Gift Tax Form 709. If, like most people, your estate will never be subject to Federal estate taxes, there will be no tax effect at all, even in the long run. If you are ultimately subject to estate taxes, however, the

current gift may increase the taxes due at that time, by using up part of the lifetime amount of gifts and estate transfers excluded from such taxes.

Sample Promissory Note

Promissory Note [provisions may be adjusted as needed]

1. Promise to Pay. For value received, _____, (Borrower) promises to pay _____ (Lender) \$ _____ and interest at the yearly rate of _____% on the unpaid balance as specified below.
2. Monthly Installments. Borrower will pay _____ monthly installments of \$ _____ each.
3. Date of Installment Payments. Borrower will make an installment payment on the _____th day of each month beginning _____, 20____ until the principal and interest have been paid in full.
4. Application of Payments. Payments will be applied first to interest and then to principal.
5. Prepayment. Borrower may prepay all or any part of the principal without penalty.
6. Loan Acceleration. If Borrower is more than _____ days late in making any payment, Lender may declare that the entire balance of unpaid principal is due immediately, together with the interest that has accrued.
7. Security. This is an unsecured note.

(signed and dated by both parties; each party receives a signed original)

For More Information

- **Outside information (general):**
 - "Loans to Friends and Family," by Roy Lewis, for the Motley Fool [online]: <http://www.fool.com/taxes/2002/taxes020816.htm>.
 - "Lending Money to Family Members," *Consumer Reports Money Adviser*, January, 2007.
 - "First National Bank of Mom and Dad," *Money*, May, 2005.
- **Government resources:**
 - IRS Publication 550 explains the tax rules for family loans, and the applicable interest rates. Go to: <http://www.irs.gov/publications/index.html>.

- ***Software to create Promissory Notes:***
 - You can Google “Promissory Notes” for various sources of sample documents and software that creates them. One such source is:
 - “Understanding Promissory Notes,” by Nolo.com, at:
<http://www.nolo.com/article.cfm/objectID/4D5D24AD-C96F-4DEE-A83DF57881D3DB55/111/277/148/ART/>