A Businesslike Approach May Prevent Problems in the Future

Should You Loan Money to a Family Member?

by Alexandra Armstrong, CFP

Odds are that at some time in your life, a family member or friend will approach you asking for a loan. This is always an awkward situation for both parties involved. Generally your best reply is that you have a policy of not lending money to family or friends to preserve good relations.

At times, however, there's a good reason to lend or give the money. For instance, you may want to help your adult children buy their first home or start a business. Of course, first you have to determine whether you can afford to do so and if so, how much you can give or loan. As a financial adviser, I've often been in the position of being the "bad guy" and telling my clients that they can't really afford to give or loan as much money as they would like. Or they shouldn't give any money at all.

There are nonfinancial reasons not to give or loan money. If you have more than one child, another child may feel that he or she isn't being treated fairly. One way to get around this is to make adjustments to your estate documents so that the amount loaned or given now is subtracted from that child's ultimate inheritance.

Lend or Give?

If you do determine you can afford to give or loan money and you think it's for a worthwhile purpose, the first decision you need to make is whether you're going to make a loan or give the money outright. If you lend the money, you have to consider what you'd do and how you'd feel if a payment was late or skipped or if you weren't repaid at all.

Instead you could give the money to the person. You can give anybody up to $14,000 per year; this is the maximum exclusion for 2016 and is periodically increased for inflation. If you're married and your spouse consents, you can give an individual a combined gift of $28,000.

A Written Agreement

If lending the money is the best financial option for you, you should set up a written loan agreement that outlines the repayment terms. We'd attach a repayment schedule with the amounts that the borrower will pay and the frequency of the payments — monthly, quarterly, annually. Both you and the borrower should sign the agreement and it should be witnessed by an unrelated party. This way both of you understand the agreement and if you aren't repaid, at least you can take the unpaid balance as a tax loss.

There are two types of loans: demand loans and term loans. Demand loans can be called at any time. A term loan sets a specific repayment period and the interest rate is locked in for this period. The Internal Revenue Service regulations for a term loan are easier to comply with, so we would recommend using term loans.

What Interest Rate Should You Charge?

Let's say this loan is for the purchase of a new home. You might want to charge the existing mortgage rate or you might not want to charge interest at all. But the IRS requires you to charge a certain minimum rate. Even if you don't collect interest, the IRS requires you to pay taxes on "imputed" interest — the interest you should have received, whether or not you actually receive it.

These rates are called applicable federal rates and are posted on the IRS website each month. The appropriate AFR is based on the length of the loan. The short-term rate applies to loans of three years or less, the midterm for three years to nine years and the long-term rate to loans in excess of nine years.

For instance, in July 2016 the short-term rate was 0.71 percent, the medium-term rate was 1.43 percent and the long-term rate was 2.18 percent.

There are two exceptions to this imputed interest rule. The first is that these rules don't apply to a below-market loan of less than $10,000 as long as the proceeds aren't directly used to buy income-producing assets

The second exception is for loans between $10,000 and $100,000. If the borrower's net investment income is $1,000 or less, you aren't required to report any interest that you forgive.

Tax Treatment of Interest Paid

Amortization schedules can be found on the internet at sites such as Bankrate.com. We'd recommend you ask your accountant to prepare this schedule for you, which will show the interest paid each year. As the lender, the interest paid is taxable interest income. If you're the borrower and if the loan is structured correctly, the interest may be deductible as mortgage interest, investment interest or as a business expense. If the money is used for personal purposes, it wouldn't be deductible.

Examples of Family Loans

One real-life example concerned a son who had multiple student loans for graduate school at various rates. The mother paid them off but then worked out a schedule her son could afford that provided her with 3 percent interest. This was much lower than what he was previously paying but was in excess of the APRs and provided her with regular income.

In another case, a widow wanted to help her only child buy a home. The adult child was married and had

two children. They needed $100,000 for a down payment. She could give the child, the spouse and the two children $56,000 (four times $14,000) in this calendar year without exceeding the gift tax exclusion. She made this gift and then loaned them $44,000. That next year she forgave them that loan using the annual gift tax exclusion again.

Other clients of mine discovered their daughter had credit card debt of $25,000 and she could afford only small repayments, mostly the interest. They sat down with her and determined the amount she could afford to pay monthly to them. They paid the debt off in full and she's repaying them monthly. Here again they're charging her an interest rate, higher than the AFR but much lower than what the credit card companies were charging. Needless to say, as part of their agreement, she cut up her existing cards.

Conclusion

The bottom line is to be very careful before agreeing to loan money to a friend or family member. If it isn't repaid, it can ruin a relationship. On the other hand, helping a child buy a first home has lasting rewards.

If you decide to loan the money, make sure there's a formal written agreement and it's clear to all this is a loan, not a gift. We recommend strongly you consult with your financial adviser and accountant before making a loan to make sure you can afford it and that you meet all IRS requirements.

A Personal Note

Regular readers of this column will note that Kelly Wright is no longer co-writing this column with me. He's joined another firm closer to his home. We'll miss his input and wish him well in his future endeavors.

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Ms. Armstrong can't answer individual inquiries, but welcomes suggestions for future article topics.

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