NATIONAL ENDOWMENT FOR FINANCIAL EDUCATION

APPROACH FAMILY LOANS WITH CAUTION

Lending money to relatives can be risky financially—and emotionally

ENGLEWOOD, COLORADO—When individuals encounter financial trouble, it's natural for them to look to family members for support by way of a loan. Keeping the transaction among relatives may appear easier than obtaining an outside loan. However, family loans are more complex than many people think, and if not executed properly, the negative consequences can far outweigh the benefits.

"Loans between family members happen all the time, but too often the parties involved don't fully understand the risks they are taking," says William L. Anthes, Ph.D., president and CEO of the Colorado-based National Endowment for Financial Education® (NEFE®), an independent, nonprofit foundation devoted exclusively to helping Americans learn about personal financial management. "The result can not only lead to financial hardship, but also bankrupt a relationship."

To navigate a family loan without a family feud, Anthes and other experts offer the following suggestions:

- **Be realistic about repayment.** Many family loans are never repaid, which often leads to feelings of bitterness and betrayal. "If you don't think your relative can repay the loan, but you want to help anyway, it might be simpler to just offer them the money in the form of a gift," Anthes says.

  Anyone, including a relative, can give another individual a gift of up to $11,000 tax free each year. Married couples can gift up to $22,000 tax free a year. Gifts that exceed those amounts must be reported to the IRS on a gift tax return, although there are exceptions. For example, anyone can pay someone else's education or medical bills without being subject to the gift limit—if the payments are made directly to the school or medical facility.

- **Ask yourself if you can afford the loan.** If you can't afford to give the money away, you probably can't afford to lend it, either, especially if there's a chance that the loan won't be repaid. Don't jeopardize your retirement or a child's education fund by making a risky loan, Anthes warns. "Be especially cautious about taking out a loan yourself in order to lend money to a relative, or getting a cash advance from a credit card," he says. "Going into debt to help a loved one is a serious step and should only be considered as a last resort."

- **Talk about the emotional consequences of a loan.** According to Kathleen Gurney, Ph.D., CEO of Financial Psychology Corporation in Sarasota, Florida, when money enters into family relationships, the dynamics change, especially when the borrower is more vulnerable and dependent than the lender. "Discuss your expectations, sensitivities and fears beforehand," Gurney recommends. "There is nothing wrong with saying, "I am fearful that our relationship will be altered by this loan if unforeseen circumstances arise that affect our agreement. Let's talk about it.'"

  As the lender, also ask yourself if you think the loan will give you the right to influence the borrower's personal decisions. This influence, no matter its intent, can create personal stress and family conflict.

  Gurney advises that all individuals who are considering loaning money to a family member ask themselves the following questions: can I emotionally afford to lose this money, can I give this money as a gift and will I still have the same feelings about the family member if the loan is not repaid? If you answer no to any of these questions, Gurney recommends reconsidering loaning your family member money.

  "The cost to the relationship is simply too high," she says. Anthes adds that if you do have to refuse to make the loan, you should be candid about your concerns and/or your own financial limitations. "While this may cause a short-term disruption in the relationship, it can avoid a bigger, and perhaps permanent, problem later on," Anthes says.

- **Understand the tax implications.** Emotional considerations aside, the rules governing the taxation of a family loan are complex enough to cause many people to think twice about making one. For example, if you make an interest-free or reduced-interest loan to a family member, and the loan is not repaid, the IRS may consider it a gift for tax purposes, whether you intended the money to be a gift or not. If this is the case, you may be required to file a federal gift tax return, depending upon the initial amount. In addition, interest earned on a family loan is considered taxable income and must be reported on your income tax return. If your return is audited and the IRS learns that you have charged less than the minimum prescribed federal interest rate, you will be responsible for paying taxes on the difference.

  Financial planning expert Keith Fevurly, CFP®, provides an example: "Let's say you loan your daughter money at a 2 percent interest rate even though the minimum federal rate is 6 percent. She makes her payments as promised, and you report the interest you receive on your tax return. Now let's say your return is audited by the

IRS, and the auditors discover the discrepancy. You will be responsible for paying taxes on the 4 percent difference even though you never received that money from your daughter."

Similarly, Fevurly says, an estate tax audit could uncover family loans that were not repaid. The IRS would likely deem these "loans" as gifts and tax them accordingly if they exceed the $11,000/$22,000 annual exclusion.

- **Make the loan an "arm's length transaction."** In other words, handle the loan to your relative as you would one with a stranger. Charge at least the minimum federal interest rate. (To find out the federal rate, go to the IRS Web site, at http://www.irs.gov/, or consult your tax advisor.) State in writing the amount of the loan, the interest rate and the repayment schedule. That way, if your relative is unable to repay the loan in full, you will have proof that a loan occurred, and you may be able to deduct the loss from your taxes. To help maintain an "arm's length transaction" you might consider working with a financial advisor. He or she may be able to screen the loan agreement for potential problems.

  In addition, if you think you could be approached by family members for loans in the future, you might want to have a loan policy. This policy would detail the types of loans you consider making, the interest rates you plan to charge, the down payment you require and any other essential criteria. This policy can help to both formalize and impersonalize the transaction.

"Family loans are more complicated that most people realize," Anthes concludes. "Before loaning money to a relative, talk it through, not only with your loved one, but also with your financial advisor. Family relationships are precious, so do everything you can to protect them from the fall-out of a loan gone bad."