

How to think about lending to friends and family

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Today's uncertain economic environment forces many people to look for alternative ways to meet their financial obligations. Stringent credit standards of traditional financial institutions have resulted in many people considering borrowing money from friends and family. Lending money can be a good source of cash flow as well as a helpful, supportive thing to do. But lending to family and friends is a delicate matter that should not be taken lightly. Before agreeing to make a personal loan, first consider the impact on your financial security, personal relationships, income taxes, and estate planning.

First and foremost, it is important to determine whether you have money to make a loan. Consider whether you can easily live without the money for the term of the loan. Even if you have extra savings, you should not loan money from your emergency fund or from your retirement fund. If repayment of the loan is uncertain or is necessary for your financial security, then do not make the loan. Instead, you might offer nonfinancial support like helping to create a budget or finding alternative sources of income. Do not put your own financial future at risk by lending money you cannot afford to lose.

If you can afford to lend money, it is important to think about how the loan could impact your relationship with the borrower as well as with other family members. To protect your relationships, consider whether you are setting a precedence. For example, if you are lending money to one family member, be careful not to establish the expectation that you are willing to make loans to others. Think about how you will handle the situation if the borrower has problems repaying the

loan. Take steps to protect your relationships by having an open honest discussion about the purpose of the loan and your expectations for repayment. Clearly written agreements can ease tensions and avoid miscommunication. Documenting your loan agreement in writing also emphasizes that the loan is a business arrangement for both parties.

A clearly written agreement also helps with required reporting to the Internal Revenue Service. You must charge interest on loans to ensure that they are not considered a gift. The IRS sets the minimum lending rates which are posted on the IRS website (irs.gov). Interest paid to a lender is subject to income tax. Use a written loan agreement to document the loan amount and interest rate as well as the length of the loan and how payments will be made. Include the payment amount, when payments are due and when any late fees will be charged. A collateralized loan requires a security agreement to secure the property. If the loan is secured with real estate, you will need a mortgage document. Be sure to keep accurate records to avoid any discrepancies. A loan for a residence or business may be deductible for the borrower. Be careful to check that your interest income matches the interest deducted by the borrower.

Loans can also have gift and estate tax repercussions. Loans to family members of a substantial amount at low interest rates could be viewed by other family members as favoritism. It is a wise idea to consult with your attorney or accountant about how any outstanding loan will be treated upon your death. You may need to amend your estate documents to accommodate loan repayments or to forgive the loan.



Lending to family and friends can be a win-win arrangement for both parties. Many people are finding that it pays to cut traditional financial institutions out of the equation. Proactively addressing possible pitfalls and using a businesslike approach to manage the loan process can help ensure a positive outcome for both the lender and the borrower.

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