



DIMEO
SCHNEIDER
& ASSOCIATES, L.L.C.

The *Advisor*

DiMeo Schneider & Associates, L.L.C.
▶ SEPTEMBER 2009

Family Loans

Summary

Many people borrow money from family members for things like a down payment on a house. A family loan can be easier to get, and have better terms, than a loan from a traditional source. But there are also potential pitfalls, for both the lender and the recipient.

When your son came to you and asked for help with a down payment on his house, you thought about Polonius' advice to his son, Laertes, in "Hamlet:" "Neither a borrower nor a lender be." But, on the other, hand, he is your son, and how can you turn him down when he has found the house of his dreams? So you agreed to help him out.

Lending money to a family member can be a win-win situation. The family member gets more favorable terms than he would get from a traditional lender, and you get to help someone you love and maybe make a little money in the process. But before you agree to a family loan, there are several things you need to consider.

First, make sure you can afford to make the loan. Don't risk your own financial security to help out a family member. Similarly, make sure the loan will be repaid. Is the borrower a good risk? Will he be able to pay back the money? Consider these questions honestly, or you could end up losing money as well as dealing with family friction.

Think about the emotional implications of a family loan. How do you feel about lending money to your child or other family member? Are you concerned that you are keeping them from taking on adult responsibility? And how will your other children feel about the loan? Will it cause dissension and unhappiness in the family?

If you go ahead with a family loan, decide on the terms of the loan and write those terms down. You might want to discuss this with a lawyer or financial expert. In general, though, be aware of the potential tax consequences of a family loan.

Uncle Sam, in the form of the Internal Revenue Service, may take a good hard look at your family loan. The IRS' concern is that wealthy family members will make a "loan" to less wealthy members, with no interest and no repayment plan, as a way of lowering the lender's taxable income and evading the gift tax. In order to convince the IRS that this is not your intent, make sure to set terms and put them in writing. Those terms should include:

- **Documentation.** You and the borrower should sign a document that clearly states that the money is a loan rather than a gift. It should include a schedule for repayment or other information about repayment expectations. This protects you against the claim that the money was really a gift. A lawyer can help you with this, but you also can do it yourself or use a prepared form available from online or text legal resources, as long as the document's terms are clear.
- **Interest rate.** Many family loans are made at below-market interest rates. But if you go too far below, you could end up in tax trouble. The minimum federal interest rate is posted on the IRS Web site. Since interest paid is income to you, you may have to pay taxes on the amount of interest that would be due under the minimum federal rate, even if you never really collect that money. This is called imputed interest. In addition, you may have to pay federal gift tax if the difference between the imputed interest and the interest that you actually received is more than \$12,000. Note: Usually small loans -- \$10,000 or less -- do not trigger the imputed tax.
- **Collateral.** If you are lending money to buy a house, you and the borrower may want to talk to a lawyer about securing the note. The borrower cannot deduct interest paid on an unsecured mortgage.
- **Additional considerations.** Many of these have to do with what happens if the loan is unpaid when you die. Does the borrower have to pay back the loan immediately, or can it be deducted from the borrower's portion of your estate? What if the value of the loan is greater than the borrower's portion? You may want to discuss these issues with your lawyer or financial adviser.