

Lending Money to Family Members

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This publication describes alternative and possible legal and emotional consequences to consider when a loan is made among family members.

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"MAY I BORROW SOME MONEY?" Economic conditions and lack of access to money from traditional lenders often result in people turning to friends or relatives for loans. Educational expenses, business start-up costs, medical expenses, purchase of a first car or house or insufficient income during periods of unemployment or retirement are situations that can trigger a loan from one family member to another. This MontGuide describes alternatives and possible legal and emotional consequences to consider when a loan is made between family members.

First of all, if you do not have the money to lend or you do not feel comfortable about making the loan, say "no" politely but firmly. Some people may feel the need to explain why they cannot make the loan. Explanations really are not necessary unless you feel comfortable revealing that information to the family member requesting the loan. Some people do not want to divulge the particulars of their own financial situation, good or bad, to another family member.

If you are financially secure and willing to lend money to a family member, you have four basic options:

1. Make the loan.
2. Co-sign the loan.
3. Designate the loan as a gift.
4. Reduce the family member's bequest by the loan amount.

Making a loan

Montana law defines the loaning of money as 'a contract by which one delivers a sum of money to another and the latter agrees to return at a future time a sum equivalent to that which he borrowed.' When repayment of the money

is expected, a formalized arrangement provides protection for the lender, for the borrower and for other family members.

One simple way to formalize the loan is with a promissory note. Although you may use promissory note forms available from office supply stores, it may be advisable to obtain the assistance of an attorney to develop a contract for your specific circumstances. The terms of the loan must be accurately and completely stated or the contract may be in question. Although loans to family members do not have to meet the federal truth-in-lending law requirements, providing the following information in a contract will be helpful to both parties:

- The amount of money loaned (amount borrowed).
- A specified date(s) when payments are due.
- An annual percentage rate (APR) of interest. To avoid potential problems with the Internal Revenue Service declaring the loan as invalid; the applicable federal rate should be used as a minimum interest rate (www.irs.gov Search Applicable Federal Rate). The amount is 2.66 percent in March 2013. Consumer loan interest is not deductible on federal income tax returns.
- The total amount of finance charge(s) in dollars and cents.
- The date on which the finance charge(s) begins to apply if it is not the same as the date of the transaction.
- Procedures if the borrower defaults on a payment.
- Property that is held as security for the loan. You may want to stipulate that the borrowed sum will become part of your estate if you die before the loan is repaid.
- Signatures of the borrower and lender.

There are several websites that can assist you in determining the payment and resulting amount of interest paid when the loan amount, interest rate and term are known. For example, the FINRA loan calculator reveals that the payment on a \$10,000 loan at 5 percent for 3 years is \$299.71. Available online at www.finra.org/loancalculator, the site also provides a chart showing the principal, interest, and balance.

If a loan to a family member is not repaid and you want to write it off as a non-business bad debt on your federal income tax, documentation will be needed to prove that the loan was 'real.' A bad debt deduction may be taken only in the year the debt becomes worthless. However, waiting until a debt becomes due to determine whether it is worthless is not necessary. A debt becomes worthless when there is no longer any chance of your being paid what was owed. For example, the bankruptcy of a family member who borrowed from you is evidence of worthlessness of the debt.

A court proceeding is not necessary if you can show that a judgment would be uncollectible from the borrower. What must be demonstrated is that you have taken reasonable steps to collect the debt.

Non-business bad debts are deducted as short-term capital losses on Schedule D (Form 1040) of the Federal Income Tax Return. For each bad debt, a statement must be attached that contains:

1. a description of the debt, including the amount and the date that it became due,
2. the name of the debtor and any business or family relationship between you and the debtor,
3. a list of efforts that you made to collect the debt, and
4. a statement indicating why you decided that the debt was worthless.

Co-signing the loan

Co-signing for a loan is another way of 'lending' money to a family member. Co-signing is a legal commitment that transfers risk from the institutional lender to the co-signer. A lender asks for a co-signer when the borrower represents more risk than the lender is otherwise willing to accept. As a co-signer, you may be asked to use your own assets as collateral for the loan.

There are two ways of co-signing a loan. An individual may be a *co-borrower* or a *guarantor* on the loan to the family member. Cosigners, under both options, are legally viewed as having borrowed the money and are liable for repayment of the loan should the primary borrower default.

If you guaranteed a debt that later becomes worthless, a bad debt deduction cannot be taken on your Federal income tax return for it unless it can be demonstrated that your reason for making the guarantee was to protect your investment or that you entered into the transaction with a profit motive.

A Federal Trade Commission rule requires creditors to provide co-signers with a notice to explain their obligations. This notice includes the following statements:

- You are being asked to guarantee this debt. Think carefully before you do. If the borrower does not pay the debt, you will have to. Be sure you can afford to pay if you have to, and that you want to accept this responsibility.
- You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees and collection costs, which increase this amount.
- The creditor can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, and so on. If this debt is ever in default, that fact may become a part of your credit record.
- This notice is not the contract that makes you liable for the debt.

Before co-signing a loan for a family member, consider these questions:

Can I really afford to repay the loan? Am I willing to repay the loan?

If you are asked to pay off the loan and cannot, you could be sued and your credit rating could be affected. Even if you are not asked to repay the debt, liability for this loan may prevent you from getting other credit you may need in the future to buy a home or start or expand a business.

Do I want to pledge my own property as collateral?

Before pledging property, such as your automobile or furniture, to secure the loan, make sure you understand the consequences. If the borrower defaults, you could lose these possessions.

What are the chances that I will be asked to repay the loan?

Some studies show that as many as three out of four co-signers are asked to repay the loan. Do you have complete faith in your family member's ability and willingness to repay the loan?

If I end up paying off the loan, what are the emotional consequences to the borrower? Will I be angry? Will this situation have a negative impact on my relationship with that family member?

How much money can I lose?

Read the fine print of the contract to be sure you are aware of your legal obligations. Are you responsible for late fees, court costs, attorney's fees and/or collection costs? Is there an acceleration clause calling for the entire balance to be paid if a payment is missed?

If you have decided to co-sign a loan, take steps to protect yourself. Listed below are ways to limit your risk as a co-signer:

- Ask the lender if your responsibility can be limited to payment of the principal balance. This would eliminate many of the other fees and charges. The lender does not have to agree, but if he or she does, it is to your advantage. If the lender does agree, request the agreement in writing.
- Ask the lender to notify you immediately in writing if the borrower misses a payment. This early notice allows you an opportunity to make the payment and avoid additional fees and problems.
- Consider a written agreement between you and the borrower to reduce your potential loss. Ask for security (collateral) and a repayment plan in case of default. Such an agreement may also encourage the borrower to meet his or her loan obligation.
- Get copies of all the documents involved (the loan contract, the truth-in-lending disclosure and any warranties). If there are any disputes, you will have all the information about the contract.
- Ask for any other agreements in writing. Misunderstandings can be prevented and the rights of everyone involved will be protected.
- Consider taking out a term life insurance policy on the borrower with you listed as owner and beneficiary in case of the borrower's untimely death.

Designating the loan as a gift

If you really do not want or expect the money to be repaid, the loan could be considered a gift to the family member. Federal law allows the annual transfer of up to \$14,000 (2013) worth of property (such as cash, real estate, stocks, bonds, or certificates of deposit) to family members or other persons without a federal gift tax due. In other words, an individual may give up to \$14,000 a

year to as many persons as he or she desires and the entire amount is excluded from federal gift taxation. The annual exclusion cannot be carried over from one year to the next. You need not file the federal gift tax return when the gifts to each person are under \$14,000.

A married couple can give up to \$28,000 (2013) worth of property a year to as many persons as they desire. No federal gift tax is due because of the gift splitting provision of the federal law. For tax purposes, each spouse is considered to have made one half of the gift, even if the entire gift was actually made by one spouse.

If a married couple makes a gift of more than \$14,000 to a third person, the Internal Revenue Service requires a gift tax return (Form 709) to be filed. The purpose is to qualify any part of the amount over \$14,000 for the annual exclusion of the other spouse, even though a federal gift tax may not be due.

There is no limit on the amount of gifts used for medical expenses or school tuition. To qualify, however, the money must be paid directly to the institution. Further information about the federal gift tax law is provided in the MSU Extension MontGuide, *Gifting – A Property Transfer Tool of Estate Planning* ([MT199105HR](#)).

If you decide to make a gift of loan requested by a family member, make it clear to the recipient at the time the money is transferred that the money is a gift. Do not leave him or her unsure of future obligations. Consider whether clarifying to other family members that the money is a gift and not a loan would enhance family relationships. Loans between family members seldom are kept secret. By making the transaction clear in the beginning, family disagreements later on may be avoided.

If the recipient of the gift is a minor (under age 21), the Montana Uniform Transfers to Minors Act must be followed. The gift funds are placed in a custodial account that is held in the name of a designated custodian for the benefit of a child. Although the assets placed in the account belonging to the child, control over them is not transferred to the child until he or she reaches the age of 21.

Montana law limits who can be custodian. The custodian cannot be the person who made the gift. When the gift is from grandparents or aunts and uncles, a parent is frequently made the custodian. An attorney can provide assistance with the appropriate legal procedure under the Montana Uniform Transfers to Minors Act. Further information is also provided in the MontGuide, *Montana Uniform Transfers to Minors Act (UTMA): Custodial Accounts for Children* ([MT199910HR](#)).

Money that is gifted to a family member or other individual is not taxed as income to the recipient. The money is also not a deductible item for the donor for income tax purposes. The donor reduces income for his or herself only to the extent of the amount of income produced by the asset that has been given away. An example would be a certificate of deposit that provides interest income of \$1,000 for the donor. By giving away the CD, the donor transfers the earning capacity of the certificate of deposit to the recipient. Gifts provide the donor with the possibility of reducing the size of his or her estate prior to death to minimize federal estate taxes. Further information on Federal estate tax is provided in the MontGuide, *The Federal Estate Tax* ([MT199104HR](#)).

Reduce the family member's bequest

If your intention is for the loan to be subtracted from a bequest to that family member upon your death, make this clarification in your will. If you have no will, the Montana law of intestate succession will not reduce the bequest to that family member. In other words, if you are leaving an estate of \$90,000 to be equally divided among three children, each will receive \$30,000 even though you had previously given one child \$20,000 to start a business. While it may have been a family 'understanding' that the gift of \$20,000 would be deducted from the bequest, the amount will not be adjusted unless there is a contract or a will clarifying the situation.

Reviewing your options

If approached by a family member about a loan, consider your options carefully. Some people find that borrowing from family can create guilt, pressure, worry and emotional trauma for everyone involved. For others,

family loans have resulted in a sense of family unity, a feeling of satisfaction in assisting a family member, and increased income for the family lender since the loan rate was often higher than the rate being paid on the money when it was in another type of investment.

If you really cannot afford to offer a financial hand to a family member, say "no." If you do not feel comfortable making a loan, say "no." If you are financially able and willing to help out, carefully consider the alternatives and select the one best for you and your family. If an amount of money over \$14,000 is involved, consult with a certified public accountant who is knowledgeable about taxes. He or she can advise you on how the gift or loan can take advantage of possible tax savings for your family situation.

No matter how casual or small the loan, put the verbal agreement into writing. Although a promissory note form may be used, the services of an attorney to establish a complete and accurate contract to protect both the lender and the borrower may prevent future misunderstandings among family members.

Disclaimer

This information is for general educational purposes only, and in no way is intended to substitute for legal advice. Legal advice, whether general or applied to specific situations, should be obtained from an attorney. Tax advice, whether general or applied to specific situations, should be obtained from a certified public accountant.

References

- Co-signing a Loan*. (March 1997). Federal Trade Commission.
- Montana Codes Annotated*, 31-1-101, 41-1-303, 2005.



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