Should I Loan Money to Family?

By Leila Martin

As soon as you start making money, chances are someone is going to ask you if they can borrow some.

There are a few key questions you should ask yourself before shelling out a loan to family or friends, from how it will affect your relationship to how it could affect your taxes. You may want to explore alternatives to a straight-out loan, or you may need to figure out how to say “no.”

“When my clients bring this up, the first thing I ask them,” said Elijah Kovar, financial advisor and co-founder with [Great Waters Financial] in Minneapolis, Minnesota, “is *why* the loan is being asked for. Is it because a bank won’t lend to them because they’re not credit-worthy? Or is this someone who pays their bills on time?”

Banks, said Kovar, have more money than we do as individuals. So if they don’t want to take the risk on a loan, we might not want to either.

Questions to Ask Yourself When Asked to Loan Money

Before you part with any money, it helps to have a realistic picture of the asker’s credit record and the reality that they may default.

Kovar recommends you ask yourself three questions:

If they default on the amount you're lending, will it affect your relationship? No loan is worth destroying a friendship or family relationship. It may be better to say "no" if you know you can't forgive a failure to repay.

If they default, is this an amount of money you're comfortable "forgiving"; that is, turning the loan into a gift? It's uncomfortable when someone defaults on a loan you gave them. But it gets even more uncomfortable if they stop answering the phone because they feel too guilty and ashamed to talk to you. If they're asking for an amount you're not willing — or can't afford — to consider a gift in the event of default, it's likely to affect your relationship, and a "no" may be the best course.

If you loan this money, are you enabling irresponsible financial practices? "Often this is parents loaning to their children," said Kovar, "and the loans are what enable their kids to just keep being idiots, which sounds awful, but it's real." He mentioned having several clients who have unpaid debts from their children and they don't want to tell him how much despite his being their financial advisor.

It's natural for parents to want to help their kids out, but it may be worth asking yourself what the asker would do if you weren't around. How would they handle it? Sometimes it's the removal of the safety net that causes family to grow up.

"People lend money to their kids because they believe in them," Kovar said, "but the trap is that in some cases they enable their children to not have to have a reality."

But if you feel a loan is the best thing for this person *and* you could handle it both emotionally and financially if they default, then a loan can be a good thing to do.

Kovar cited, for example, one couple whose son decided in his early twenties that his interests lay in real estate: responsible, but too young to have established enough credit to qualify for a bank loan and not in possession of the capital necessary to break into real-estate investing.

“It was completely reasonable for them to help him get going,” Kovar said, “and the way they did that was by being the bank. They gave him startup capital for his real estate business on a full amortization schedule, just like a mortgage would be, and had their lawyer draft a formal agreement so that, if necessary, they can foreclose on him just the way a bank would be able to.”

Alternatives to Direct Lending

Loans to family tend to be informal: you hand over money with the expectation (or at least the hope) that you’ll get that money paid back to you eventually. Most informal lending agreements in this vein don’t charge interest, and other than assuming a zen attitude there’s not much you can do about it if you never see that money again.

But there are other ways to help someone out without just handing over a wad of cash.

Say you’ve got a kid who is generally responsible and pays their day-to-day bills without a problem, but suddenly their car needs to be replaced and they can’t make a down payment.

“If you’re going to give someone money to buy a car,” Kovar said, “one thing I’ve seen very responsible parents do is seize the opportunity to teach a life lesson. They say: I’ll help you, but as the bank, not the parent. I’ll buy the car. The title will be in my name. You’ll make payments on a schedule until it’s paid off, at which point we’ll transfer the title to you. But, if you’re ever thirty days late with a payment, I’ll repossess the car.”

These terms are harsher than what a bank would generally enforce, said Kovar, but that’s not necessarily a bad thing. “It’s not being mean. It’s giving a loan, in a way, but with high standards.” In a way, it shows great faith that the borrower will be able to pay the loan back, but the ability to repossess the property also protects the lender in the event of default.

Loaning Money: Tax Considerations

Acting as the bank adds a level of formality to a personal loan, but depending on the amount you may want to consider adding another layer on top of that with formal, legal documentation of the loan. This can help protect you when it's time to file your taxes.

For starters, said Joan K. Morrow, a certified public accountant and partner at Denet Kenefick & Associates, P.A. in Mendota Heights, Minnesota, legally documenting a loan keeps it from being classified as a gift and counted against your gift tax exemption. In order to prove to the IRS that this absence of money is a loan and not a gift, you need to have legal documentation, which can be done through your lawyer or, if you don't have one, using customizable agreement forms.

The IRS wants to see that you have the legal document proving the loan. In addition, you must charge at least the minimum federal interest rate, which you must then claim as income on your tax return each year until the loan is paid back.

Morrow noted that if the loan is a mortgage, you may need to record it with the county in which the property is being purchased. In addition to the lender having to claim interest as income on their tax returns, the borrower would get to deduct the interest on their taxes just as they would with a bank mortgage.

The other reason to formalize larger loans is to protect the lender from loss in the event of default.

Individuals are not banks, and most people don't make their income through loaning money. Banks that give loans have protections in place, but an individual who chooses not to formalize a loan loses that money if the borrower defaults.

Remember that a loan is an investment, and formalizing a loan means that if the borrower defaults, you can claim a capital loss just like you would if you lost money in stocks, mutual funds, or any other investment. This can affect your taxes, too; the IRS states that if your capital losses exceed your capital gains, the excess can be deducted on your tax return and used to reduce other income, such as wages, up to an annual limit.[1]

“Let’s say,” said Kovar, “I give a $50,000 loan to my son. He defaults. The market was down and I had no capital gains in my portfolio. So I’ll hold on to my loss for future tax years, and I can write off up to the annual maximum deduction each year against future capital gains until the balance of the loss is eaten up.”

It works just like ordinary gains and losses, said Kovar, because it’s a non-business debt if you’re not in the business of lending money, but formalizing the loan gives you at least some of the benefits a bank would have if default happens.

Saying ‘No’ to a Loan

Sometimes, though, you have to say no, especially when lending money means dipping into your retirement savings or otherwise endangering your own financial well-being.

“Younger adults don’t understand that having a million dollars saved often means a modest retirement,” said Kovar. “They think mom and dad are rich. They’re not thinking about their parents’ well-being when they ask for these loans.”

This can be awkward, especially if it’s your family asking. Parents feel like they’re being bad people by not helping out their kids, Kovar said, even when it means endangering the retirement savings they’ve worked long and hard to put away.

Whether you’ve decided the would-be borrower is a bad investment or you just can’t afford to part with the money but you feel too guilty saying no, Kovar proposes a simple solution: blame it on your advisor.

“Go to your financial advisor and ask them to tell you not to give money to your kids,” he said with a smile. “We don’t mind helping you preserve your financial well-being. That’s what we’re there for.”