BE CAREFUL WHEN MAKING FAMILY LOANS

It's common for parents or grandparents to lend money to adult children. It's also common for such loans to make everyone unhappy—the lender, the borrower, other family members, even the IRS.

The first clue as to whether a family loan could be trouble is the nature of the loan. A loan for the down payment on a first home or seed money for a promising business startup might be one thing. Bailing out a child or friend who's perpetually in debt is another. Choose your loans carefully.

One way to look at a family loan is to figure it'll never be repaid and simply chalk it off as a gift. You might even consider it an advance against the child's inheritance. However, other family members may resent that you're not loaning them money, too, or they may expect the family member to pay back the estate when you die. It might be a good idea to discuss any sizable loan with the other heirs to make clear why you're lending money and whether you intend to have it paid back or whether it is an advance against their inheritance. Loaning a family member or friend money you don't realistically expect to be paid back also can create serious tax consequences, which will be discussed shortly.

Most Certified Financial Planner practitioners recommend that if you're going to loan money to a family member or friend that you put the loan in writing. Be clear about the amount you're lending, what interest you're charging, payments, due dates, and even late fees. This benefits you and the borrower, and can help if there is any dispute with the Internal Revenue Service about the loan.

As long as the total loan is for less than $10,000, the IRS is probably not going to care about the loan. That's because you can gift up to $10,000 a year free of gift tax (or $20,000 if it's a loan from a married couple). The exception to this rule is if the borrower uses the money to buy income-producing assets. Above $10,000, loans get a bit more complicated.

As you might expect, you can't just hand a child or friend tens of thousands of dollars, call it a loan, and then simply forgive it. Otherwise, people would use "loans" to shift assets to heirs free of gift or estate tax. Consequently, any time you loan more than $10,000, you must charge an interest

rate that is at least as much as a minimum IRS rate—known as the applicable federal rate. In April 1999, that rate ranged from around 5 percent on short-term loans (less than two years) to about 5.7 percent on long-term loans (over seven years). If you make an interest-free loan or charge less than the applicable federal rate (below market rates) you may have to pay income tax on the imputed interest you should have received.

For loans up to $100,000 that are not invested by the borrower, you won't pay any tax on imputed interest as long as the borrower doesn't earn other net investment income over $1,000. If investment income exceeds $1,000, you pay income tax only on imputed income that equals the borrower's net investment income. For loans over $100,000, you'll pay income taxes on the phantom interest regardless of how the money is used.

What happens if your child or friend fails to pay back the loan? First, you can always forgive up to $10,000 of the loan each year ($20,000 for married couples). Second, the IRS may try to recharacterize the loan as a gift. This is where good loan documentation can be invaluable. It also helps if there is at least some history of repayment, and if you can show efforts at trying to collect, including selling loan collateral or, heaven forbid, suing.

Clearly, loaning to family or friends should not be done casually. It can damage not only personal relationships, but cause income tax and estate planning problems. Work with your Certified Financial Planner professional and attorney to be sure everything is in order.

May 1999—This column is produced by the Institute of Certified Financial Planners, a national association representing the top financial planners in the country, and is provided by Joseph Hoffman, a local member in good standing of the Institute.