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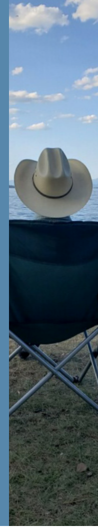

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FAMILY FINANCIAL MANAGEMENT

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# 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.*

**"MAY I BORROW MONEY?"** Economic conditions and rejections from traditional lenders often result in people turning to friends or relatives for loans. Educational expenses, business start-up costs, medical expenses, the purchase of a first car or house or insufficient income during periods of unemployment or retirement can trigger a loan from one family member to another.

If a family member approaches a parent, siblings or another family member about borrowing money, each should take the time to weigh options. They should consider the boundaries and expectations to ensure family relationships stay intact and how both can protect their financial well-being. If a family member does not have money to lend or does not feel comfortable making a loan, saying "no" politely but firmly is okay. Some people may feel the need to explain why they cannot make a loan. Explanations are not necessary unless the person feels comfortable revealing the information to the family member requesting the loan. Other people may not want to share the particulars of their own financial situation, good or bad, with another family member.

There are four potential options if a family member is financially secure and willing to lend money to a family member:

1. Make the loan.
2. Co-sign the loan.
3. Designate the loan as a gift.
4. Reduce the borrower family member's inheritance 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 the amount borrowed.* When repayment of the money is expected, a formalized arrangement in writing provides protection for the lender, the borrower and other family members.

One simple way to formalize the loan is with a promissory note, which is a written promise to repay a loan. Although there are promissory note forms available from office supply stores and online, hiring an attorney to develop a contract for a specific loan from the family members is advisable. Terms of the loan must be accurately and completely stated, or the contract may be in question. Although loans among family members do not have to meet the federal truth-in-lending law requirements, providing the following information in a contract is 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'). For example, the APR as of March 2025 for a loan of more than nine years is 4.71 percent.
- The total amount of finance charges in dollars and cents.
- The date on which the finance charges begin to apply if they do not begin on the same date as the transaction.
- Procedures if the borrower defaults on a payment.
- What property, if any, will be held as security for the loan.
- A family member may want to specify that the balance of the borrowed sum becomes part of their estate as debt owed if the borrower dies before the loan is repaid.
- Signatures of the borrower and lender.

Websites are available to calculate the payment and resulting interest paid when the loan amount, interest rate and length of the loan are known. For example, the Financial Industry Regulatory Authority (FINRA) loan calculator reveals that the monthly payment on a $10,000 loan at five percent for three years is $299.71. The FINRA website also provides a chart showing the principal, interest, and balance after each monthly payment (loancalculator.nga.finra.org/calculator).

If a loan to a family member is not repaid, the lender may want to write it off as a non-business bad debt on their federal income tax return. In such cases, documentation is needed to prove that the loan was 'real,' as a bad debt deduction may be taken only in the year the debt becomes worthless. However, waiting until a debt becomes due to figure out whether it is worthless is not necessary. A debt becomes worthless when there is no longer any chance of the family member being paid the amount owed. For example, the bankruptcy of a family member who borrowed money is evidence of the worthlessness of the debt.

A court proceeding is not necessary if a person can show a judgment would be uncollectible from the borrower. What must be proven is that the family lender has 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 with the following information:

1. a description of the debt, including the amount and the date it became due,
2. the name of the borrower and any business or family relationship between the lender and the borrower,
3. a list of efforts made to collect the debt, and
4. a statement saying why the decision was reached 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 an institutional lender to the co-signer. A lender asks for a co-signer when the borrower has more risk than the lender is willing to accept. Co-signers may be asked to use their 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 a family member. Either way, they are co-signers and are legally viewed as having borrowed the money. They are liable for repayment of the loan should the primary borrower default.

If a lender family member guarantees a debt that later becomes worthless, a bad debt deduction cannot be taken on their federal income tax return unless it can be shown that the reason for making the guarantee was to protect their investment or they 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 the family member defaults on the loan, and you want to accept this responsibility.
- You may have to pay 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 the amount.
- The creditor can use the same collection methods against you that can be used against the borrower, such as suing you or garnishing your wages. If the debt is ever in default, this fact may become a part of your credit record.

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

1. **Can I really afford 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 loans you may need in the future to buy a home or start or expand a business.
2. **Do I want to pledge my own property as collateral?** Before pledging property, such as your home, automobile, or furniture, to secure the loan, be sure you understand the consequences. If the borrower defaults, you could lose any possessions pledged as collateral.
3. **What are the chances I will be asked to repay the loan?** Some studies show that three out of four cosigners are asked to repay the loan. Do you have complete faith in your family member's ability and willingness to repay the loan? If, as a co-signer, you end up paying off the loan, what are the emotional consequences? Will you be angry? Will this situation have a negative impact on your relationship with family members?
4. **How much money can I afford to 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 strategies to limit risk as a co-signer:

- Ask the lender if your responsibility can be limited to payment of the principal balance. This would eliminate other fees and charges. The lender does not have to agree, but if they do, it is to your advantage. Should the lender 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 to make the payment and avoid added late fees and problems.
- Maintain an open dialogue with the borrower about the loan's status. Early awareness of potential payment issues is in everyone's best interest and prepares you to act promptly should you need to make a payment.
- To reduce your potential loss, consider a written agreement between you and the borrower. Ask for security (collateral) and a repayment plan in case of default. Such an agreement may also encourage the borrower to meet their 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 loan agreements in writing. This will prevent misunderstandings and protect the rights of everyone involved.
- Consider taking out a term life insurance policy on the borrower with you listed as owner and beneficiary in case of the borrower's sudden death.

## Designating the loan as a gift

A loan may be considered a gift if you do not want or expect the money to be repaid by the family member. Federal law allows the annual transfer of up to $19,000 (2025) worth of property (such as cash, real estate, stocks, bonds, or mutual funds) to family members or other people without a federal gift tax. In other words, an individual may give up to $19,000 a year to as many people as they want, and the entire amount is excluded from federal gift taxation. The annual exclusion cannot be carried over from one year to the next. The federal gift tax return does not need to be filed if gifts to each person are under $19,000.

A married couple can give up to $38,000 (2025) value of property a year to as many people as they want. 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 ($19,000), even if one spouse made the entire gift.

If a married couple makes a gift of more than $19,000 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 $19,000 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), store.msuextension.org/Products/Gifting-A-Property-Transfer-Tool-of-Estate-Planning-MT199105HR__MT199105HR.aspx.

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

Money gifted to a family member or other individual is not taxed as income to the recipient. Also, the money is not a deductible item for the donor for income tax purposes. The donor reduces income only to the extent of the amount of income produced by the asset given away. An example would be a certificate of deposit (CD) that provides interest income of $1,000 for the donor. By giving away the CD, the donor transfers the earning capacity ($1,000) of the certificate of deposit to the recipient.

## Reduce the family member's inheritance

If a family lender's intention is for the loan to be subtracted from an inheritance to the borrower family member upon the lender's death, this clarification can be made in a Will. If the lender family member does not have a Will, the Montana law of intestate succession does not reduce the inheritance to the borrower. In other words, if a parent were leaving an estate of $90,000 to be equally divided among three children, each would receive $30,000. Yet the parent gave one child $20,000 to start a business. While there may have been a family 'understanding' that the gift of $20,000 would be deducted from the borrower's inheritance, the amount will not be adjusted unless there is a contract or a Will clarifying the situation. Information on Wills is available in the MontGuide, *Wills* (MT198906HR), store.msuextension.org/Products/Wills-MT198906HR__MT198906HR.aspx.

## Reviewing the options

If approached by a family member about a loan, consider options carefully. Some people find 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 helping 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 a person cannot afford to offer a financial hand to a family member without feeling the strain on their own finances, they can say no. If a person does not feel comfortable making a loan, they can say no. If a person is not financially able and willing to help, carefully consider the alternatives and select a choice that is best for the family. If an amount of money over $19,000 is involved, consult with a certified public accountant (CPA) who is knowledgeable about gift taxes. A CPA can make recommendations about using the gift or loan to take advantage of tax savings for a family situation.

No matter how casual or small the loan is, put the agreement in writing. Although a promissory note form may be used, the services of an attorney to set up a complete legal contract to protect both the lender and the borrower may be worthwhile to prevent future misunderstandings among family members.


## Acknowledgments

Representatives from the following reviewed this MontGuide and recommend its reading by all Montanans who are interested in making a loan to a family member.

- Business, Estates, Trusts, Tax and Real Property Section, State Bar of Montana
- Montana Society of Certified Public Accountants


## Disclaimer

This information is for general educational purposes only and is in no way 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 FAQs. Federal Trade Commission. September 2023. consumer.ftc.gov/articles/cosigning-loan-faqs

*2023 Montana Codes Annotated*, Title 31. Credit Transaction and Relationships, Chapter 1. Credit Transaction Part 1. Loans of Money: What Constitutes. leg.mt.gov/bills/mca/title_0310/chapters_index.html



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