



Related Party Loans: Becoming the Family Banker

It is not uncommon for family members to loan money to each other if the need arises. These “related party” loans are often given with the best intentions and, most of the time, are repaid timely and without any serious problems. However, there are some things to think about before lending or borrowing money to or from a family member.

Consider Your Relationship

Related party loans can taint otherwise good relationships. The lender often feels the borrower shows little gratitude. The lender will expect the borrower to make timely payments without being reminded. Yet if a phone call has to be made or a note written, tempers may flare. The lender may also expect the borrower to make financial sacrifices while the loan is outstanding; but when the borrower takes a long vacation or makes a large discretionary purchase, the lender will be offended.

On the other hand, having to borrow money from a family member can be a source of embarrassment for the borrower. Most borrowers reduce personal spending while such loans are outstanding, but they typically do not expect to cease all leisure activities. The borrower may become upset and resentful when their personal spending choices come under scrutiny, especially when the loan is being repaid on time.

There may be more implications in a related party loan than you initially consider. A family rift may arise if the loan carries a favorable interest rate and is made to one of many children. Those who do not receive the loan may think the parents are playing favorites, or that the borrower is taking advantage of the parents. Further, loaning to one family member may “open the door” to others requesting a similar financial favor.

You must be prepared at some point to say no – if not only out of necessity, out of the fact that making such a loan may complicate your relationship with the borrower. The basic rule is if you cannot afford to lose the money, do not loan it.

Written Agreement

If you are going to loan money to a family member, get it in writing. The borrower may be offended at the idea of signing a loan contract (known as a “promissory note”), but we

highly recommend you insist on having a formal document drawn up. The promissory note will protect all the parties involved from misunderstandings and miscommunication, and gives the lender recourse should the borrower become unable or unwilling to repay the loan.

Asking for a promissory note from a family member can be an awkward endeavor. Doing so can send a very clear message: “Of course I trust you, but...” If you decide that making the loan is the right thing to do, putting the matter in writing is appropriate and customary for the lender. Signing papers provides an opportunity for the borrower to demonstrate he or she is a good risk.

While you need no justification for requesting a promissory note, you might find being armed with external reasons will make the requirement less personal. In order to help smooth through the paper process, you might point to the professionals for insisting on the written documents by indicating that your financial advisor, accountant or lawyer (or even all of them) absolutely insists on it. Mention an article that illustrates the potential problems with related party loans, and that you understand the best way to prevent issues is by a written agreement. Finally, you might tell the borrower that you need a formal document in case you are audited by the IRS.

Terms & Conditions

A well-crafted promissory note should contain the following provisions:

Purpose

The note should set forth the borrower’s intended use of the loan proceeds. If the funds are not used for the intended purpose, the note might permit the lender to demand the loan be immediately repaid. Or, the interest rate might be increased to penalize the borrower. To ensure the proceeds are used for the intended purpose, consider making the check payable to the third party vendee. So, if the loan is to help with a child’s education, or assist in making a mortgage payment, the lender should consider making the check directly payable to the educational institution or mortgage bank. However, doing so may have adverse income tax consequences (e.g., mortgage interest may not be deductible, or an education credit may not be available).

Interest Rate

Remember that when you take money from your savings or investment account to make the loan, you are losing interest income. It is only reasonable that you are compensated for the loss. If you are inclined to charge a low rate of interest, be aware that there are income tax implications (this is covered in a later paragraph). Make sure a fair interest rate is clearly stated. If the borrower fails to make all the payments on a timely basis, the note might require the interest rate be increased as a penalty for the default.

Changes in Writing Only

Often times, after the loan is made the borrower and lender will engage in certain actions or make certain statements that are later misinterpreted as a permanent change to the note. For example, the lender may forgive the interest one year, and the borrower may come to expect that future interest is forgiven. So, the note should require that any changes to the loan or payments be in writing and signed by both parties. Verbal changes should be null and void without exception.

Repayment

Loans may be repaid in equal installments, usually monthly. Installment loans are typically payable over a term of years. Alternatively, the loan may be payable on demand of the lender, meaning the lender may require repayment of the entire loan at any time. Demand loans are usually payable in full with interest at a certain date in the future if the lender does not demand full payment earlier.

Make sure that the timing, frequency and amount of each installment or demand payment is practical for the borrower and acceptable to the lender. Late payments are the most common cause of dispute. Consider both parties' future cash needs, and build in a cushion in case there are difficult times.

The amount of the loan, timing of repayment, and interest rate factor into the amount of the borrower's payments. The note should have an amortization schedule attached that breaks down the amount of interest and principal in each payment. Amortization programs may be used to calculate the amount of each payment and may be found on the Internet. A loan calculator is available at [GoldAllianceGroup.com financing](http://GoldAllianceGroup.com/financing).

Confidentiality

Ideally, the very existence of the loan and all the related circumstances should remain confidential. Confidentiality is a two-way street, and both the borrower and lender (and all of those necessarily privy to the loan) should agree in writing that they will not discuss the loan with any other person. While there are practical challenges to enforcing confidentiality, putting the provision in a signed promissory note will help impress upon everyone the importance of keeping the matter quiet.

Collateral & Collecting

A promissory note is a mere promise to pay. If the borrower is unable to pay, the lender will have to bring a lawsuit to collect. A borrower who stops paying probably has serious financial problems and others creditors. If collateral is available, taking an interest in it is a way to ensure payment and puts the lender in front of other "unsecured" creditors.

The lender should consider having the borrower's spouse (if married) join in signing the

promissory note so that the parties are “jointly and severally” liable. That means if there is a default, the lender can go after either or both parties, and the borrower cannot use his or her marital status as a shield to protect their assets and avoid repayment.

Maintaining Records

It is never a good idea to give cash for a loan or, for that matter, accept cash for repayment. Even when you have a signed promissory note, you still need a record of the money exchanging hands. Using a personal check is an effective way of maintaining a paper trail. In all cases we recommend that a copy of the check be maintained in the lender and borrower’s file. If you do give or take cash, make certain you maintain a written receipt, dated and signed by both parties.

Do make sure you keep a record of every payment so there is never a question of how much has been repaid. Always make a reference in the memo section that the check represents a repayment of the loan, particularly since family members sometimes write each other checks for other reasons.

Life Insurance for Protection

If the borrower dies, continuing to collect on the note is significantly complicated. In such cases, collection of the balance of the note is sometimes impossible. If the loan is substantial enough and contemplated to be paid over a long period of time (exceeding 10 years), you might consider purchasing term life insurance on the borrower to ensure full repayment.

Income Tax Consequences

Family members are typically reluctant to charge each other any interest. Even if interest is not actually collected, however, the IRS may treat the lender as having received interest income for income tax purposes (“imputed interest”). So, the lender will have to pay incomes taxes on the imputed interest, even if he or she received no interest or other payments. There are exceptions to the imputed interest rule. If the loan is for less than \$10,000, the IRS will not impute any interest. For larger loans up to \$100,000, the IRS will not impute interest provided the borrower has less that \$1,000 in dividends and interest.

Conclusion

Related party loans have far reaching implications for the lender and borrower, including the relationship with each other and the rest of their families. Never loan money you cannot afford to lose, and always put the terms of the arrangement in writing. Both parties should keep good records of all payments. If the borrower has assets, it may be a good idea for the lender to use the assets as collateral to secure the loan. Do not forget the income tax consequences involving all loans as Uncle Sam may not be as forgiving as

a family member. If you are contemplating a related party loan or have already made one, we hope you will rely on us for advice and counsel.

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