LOANS

4 Steps to Keep Family Loans From Escalating Into Fisticuffs

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Talking about money with family members is often taboo, and for good reason. Money can create resentments and misunderstandings. And while family members do ask one other for money, those doing the lending need to do their homework before handing over the cash.

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“The heart of the issue is, if you borrow from a family member, there’s risk because it can cause damage to the personal relationship, depending on how that loan is handled and the expectations from the borrower and the lender,” says Katherine Dean.

Adds Dean, managing director of wealth planning at Wells Fargo Private Bank in North Carolina: “[Family loans] can work, but only if the loan is paid back carefully, and care is given throughout the relationship.”

So, unless you consider the loan a gift, be prepared for problems to arise when your family member doesn't pay you back, as collecting on a loan can be awkward for borrower and lender alike. Here are four steps you can take to protect yourself from any financial and emotional consequences and to preserve your relationship.

1. Review your own finances first

Understand your financial situation. “You must take care of yourself first, and anyone else comes second,” says Michael Eisenberg, a certified public accountant based in Los Angeles. “You don’t want to be lending or gifting money and then find out that your lifestyle is impacted or you can’t pay your own living expenses.”

2. Ask "why?"

You have to be comfortable asking about the borrower's intentions for this money. The conversation may change, depending on your family member's reasons for the loan.

If the borrower has financial struggles, a family loan should be a last resort. The borrower needs to show that he or she is working to improve finances and has a plan for the money. If, instead, you micromanage by dictating a budget, that action will feel punitive and add fire to an already tense situation.

Other circumstances do warrant a deep dive into your relative's plans, particularly the start of a new business. Since you face the risk that your money will be spent on something that won't generate enough revenue to pay you back, you will want to understand the borrower's plan and hopefully have the business savvy to do that.

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"If [a business owner] were to go to a bank, private equity firm or anywhere else, they'd need a business plan and projections," says Beth Gamel, a certified public accountant financial planner and managing director of Argent Wealth Management, in New York. "This raises the conversation to a higher plane and gives the lender permission to ask tougher questions than if someone was looking for money to tide them over."

A business plan shows that your relative developed the idea and has a plan for building the resulting venture. "If you're not getting that, you have to question whether you're going to invest," says Eisenberg.

If you do decide to move forward, you can either provide a traditional business loan or invest in the business by taking an equity stake, but the two actions are different. "A loan is repaid over time while an investment in the business is in exchange for an active role in the business," explains Wells Fargo's Dean.

While an equity stake will give you more control over your money, you should think about its long-term ramifications and whether you want a role in the business.

Above all, don't be afraid to say no. "The person who's being asked for the money -- if this is not a business that they think is viable, they owe it to their family member to say '[I] won't invest in it unless [you] can tweak the concept, get more experience or bring people into it who have more experience,'" advises Gamel.

3. Disuss the loan terms.

"You want to have a discussion and lay out all the terms and conditions and your expectations as a lender," says Eisenberg. "If you can get collateral and security, that will add to your peace of mind. Otherwise you're going on faith and hope that you get paid back."

Collateral could be equity in a house, or stocks or whatever else you believe will yield value.

Interest is another important part of the discussion, and you'll want to set these terms for a few different reasons. "The interest rates you could charge someone are so low that you can test the waters on whether they would pay you back by talking about a repayment plan," says Gamel.

The IRS publishes the Applicable Federal Rates (AFR) tables that cover loans to family members. "They set a base for what the rate should be before it's considered an actual gift," says Gamel.

AFR rates change monthly and vary depending on the loan term, but are generally lower than market rates. As of August, short-term loans for less than three years had a monthly rate of 0.48 percent; midterm loans between three and nine years were at 1.80 percent; and long-term loans extending beyond nine years were at 2.78 percent.

"If you can start talking in those terms to someone looking to borrow, the borrower will see this as a business arrangement at extremely favorable rates," says Gamel.

Additionally, the IRS considers any interest that's waived to be a gift, and this money is taxed as ordinary income whether you receive it or not. "If you want to use that $14,000 [annual] exclusion, or if you're going to get into the lifetime exclusion, file the gift tax form," says Dean.

4. Formalize the loan.

"If you want the money back, absolutely you should get it in writing and there should be a contract," says Randy Kessler, founding partner of Kessler & Solomiany, LLC, in Atlanta.

A loan agreement and promissory note that's signed, notarized, dated and witnessed will give the lender something to rely on if the money is not repaid. A security interest secures the collateral pledged to a loan, while an ownership interest documents an equity stake in a business.

This paperwork serves another purpose if you're not repaid: your tax return. "You want to have your documentation in order so that when you write this back as a 'bad debt,' you have a paper trail," says Eisenberg.

Within the paper trail, you should be prepared to show any payments received and your collection attempts through email or certified mail, as well as any responses you received.

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