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Terry Herr of Herr Capital Management says you shouldn't lend money to chronically irresponsible relatives.

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More than money is involved when relatives borrow

By Judy Artunian Special to the Tribune

If your sister starts singing "Brother, can you spare a dime?" consider it a clue that there is more at stake than money.

What begins as a straightforward transaction can quickly disintegrate into a family rift over why you can't give your sister an interest-free loan, or why your son got a bigger financial assist with his first car than your daughter got for hers.

It can be hard to say "no" to a family member, especially a responsible adult child who asks for help buying her first house. According to Elizabeth Lewin, the Westport, Conn.-based founder of Financial Fitness Unlimited and the co-author of "Family Finance," the child needs to consider the parent's situation, too.

"Adult kids should think twice before asking for help," Lewin said. "The parent may be getting close to retirement with a nest egg that may have eroded last year. It's difficult for a parent to say to a child, 'I can't lend you the money because my portfolio is 50 percent less than it was two years ago.'"

If you do decide to extend a loan, be clear that it's a loan and not a gift. Banks require collateral and formal loan agreements, but family members tend to take a more casual approach. You may feel awkward about demanding collateral and a strict payment schedule from a sister who just lost her job and is in a fragile emotional state. But doing so can keep future family squabbles at bay.

"A family member might say, 'If you love me, you won't have to put it in writing.' But if they can't borrow money in a business-like fashion, you probably shouldn't be lending them the money," said Terrence Herr, a principal at Herr Capital Management in Chicago.

With a written loan agreement, all parties know what is expected. And while you're unlikely to take a family member to court to collect on a bad debt, consider what could happen if the borrower dies before repaying the loan. If you don't have a written loan document, the executor isn't legally obligated to repay you out of the borrower's estate.

Your loan agreement should spell out the amount of money borrowed, the repayment schedule, the annual percentage rate of interest, the date when the finance charges begin to apply and a list of property that you may be holding as security for the loan. The IRS has its own definitions of a loan versus a gift. You can give another person up to $11,000 annually and the IRS will consider it a tax-free gift. If you give more than 11,000, however, it's considered a loan and the IRS expects you to charge interest to the borrower. Your interest rate has to be higher than the published rate from the IRS. You can give the borrower a break by charging him less than the applicable federal rate, but it will cost you. The interest you receive on the loan is taxable and you'll be taxed for the difference between your bargain rate and the applicable federal rate.

According to Eva Rosenberg, president of Las Vegas-based Taxmama.com, even though you're taxed on the interest income, you can still come out ahead.

"Lending can be a win-win situation," she said. "If you're lending to a family member with great credit who could get a mortgage loan at 5 percent, now you can earn 5 percent and they don't have to go through the paperwork needed for a public loan.

You can make an interest-free loan of up to $100,000 to a family member if the borrower's net investment income-their total income from dividends, interest and capital gains-doesn't exceed $1,000 a year: You can also give an unlimited amount of tax-free gifts for medical expenses and college tuition, as long as you make the payments directly to the medical provider or educational institution.

As usual, where taxes are involved, there are some wrinkles to consider.

For example, if bad credit is keeping a family member from buying a house, it's not uncommon for another family member to make the down payment, take out a mortgage and then have the credit-challenged relative make the payments directly to the mortgage company.

"I see this happen a lot, but the problem is that to deduct the mortgage interest on a home loan, you have to be living in the home, and you have to be the one who owns the title and whose name is on the loan," said Rosenberg. "So the person living in the home can't take the deduction, and neither can the person who borrowed the money and bought the house."

The solution? Make it clear in the contract of sale that the person who is living in the home is making payments directly to the mortgage company. That way he can take the mortgage interest payments as a tax deduction. "The trick with taxes is that you can do almost anything as long as you put it in writing and make it clear what your intentions are," said Rosenberg.

Co-signing on a loan may be less demanding on your checking account right now, but if your sister defaults on the loan, you become responsible for it. Your credit report could take a hit in the process.

According to Robin Stone, a CPA with Leonetti & Associates in Buffalo Grove: "The most important issue people forget when they co-sign is that the credit history goes along with it, even though you're initially not responsible for the payments."

Despite your good intentions, lending or giving money as a gift to family members can wreak emotional havoc that takes years to resolve, if it's resolved at all.

According to Mark Kopta, chairman of the psychology department at the University of Evansville in Indiana: "Even if we want to think we're above it, many of us, when we lend someone money and they don't repay it, feel a sense of insult and betrayal that our loan didn't mean enough to that person for them to pay it back. The person you lent the money to might get angry at you, too. It sounds irrational, but they sometimes blame you because they feel that if you hadn't lent them the money, they wouldn't be in this situation."

There is also the potential for family jealousies. If you're helping one child, it's best to inform your other children of what you're doing and why, so they don't find out later through the family grapevine.

Finally, don't bail out a chronically irresponsible family member: "Never throw good money after bad," said Herr: "If they're really bankrupt, let them declare bankruptcy and then help them later: Offer to pay for them to take consumer education classes. Help them learn to manage their money so they won't get into that position again."

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