



We frequently assist clients with loans to family members and, more rarely, to friends. Often loans are made without a signed promissory note, which can present problems, especially in the event of the lender's death when the borrower insists it was really a gift. A written promissory note can minimize the potential for misunderstandings about the intentions and the potential for non-payment.

### Some Considerations

There are risks in any loan. Default, if the amount is not great, can be treated as a gift to the family member with a little tweaking of the estate planning documents, especially for equalization purposes (see below). Sometimes the borrower returns for more, which may raise questions about the borrower's financial management that would need to be addressed.

Proverbs 22:7b says: "the borrower is the slave of the lender," or as one financial guru observes "Thanksgiving dinner may not taste as good knowing that you are owed a debt by someone at the table." Clear communication of expectations will be important in helping minimize bad feelings. Best practices include:

- There should always be a promissory note that states the amount, the interest rate, and the due date.
- The note should be business-like and can be secured by a mortgage if the borrower is interested in a tax deduction for interest paid on a residential mortgage. However, if there is an existing mortgage, the primary lender may need to consent to the filing of an additional mortgage.
- The IRS publishes minimum required rates every month – it is best to use these rates, although higher rates can be charged.
- If the amount exceeds \$100,000, gift loan provisions of the Internal Revenue Code will apply, so greater formality is essential in order to avoid unexpected deemed income and tax complexities.

Loans to family members may need to be addressed in the estate planning process. Even if a loan is not properly documented, the loan balance will be part of the lender's estate. If the borrower is a beneficiary, the loan balance can be distributed to the borrower as part of the borrower's inheritance. This causes the loan to disappear. If the loan balance is larger than the borrower's share of the estate, sizable, the borrower will continue to owe the excess to other family members, possibly leading to strained family relationships. As part of their estate plan, some lenders may direct any balance to be an additional inheritance to the borrower – this may frustrate the intent to be equal, but it will eliminate the continuing debt to other family members. Another potential issue may arise if the spouse of the family member divorces and denies any responsibility.

As stated above, loans to friends are not as common and need to be fully documented. It isn't likely that you intend to make a friend a beneficiary of your estate.

Obviously, loans can enable the borrower in many ways, but the potential downsides should not be overlooked.



### ROGER SHUMAKER

With 40+ years of estate planning experience, I provide peace of mind by helping you design and implement an estate plan that will address your circumstances and objectives.

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