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Don't make lending a family affair

By Steve Bucci • Bankrate.com



Q: Dear Debt Adviser,

I have read that we should not lend money to family members. I understand that such transactions might not have the formal documentation of a standard bank loan. But is there any legal way to lend money to a relative? What is your opinion of a legally binding loan contract that is drawn up by lawyers? Could this be one way of assisting a relative in need?

-- Anna D.

A: Dear Anna,

Yes, I am one of the many people who have cautioned people about the pitfalls of lending money to family members. However, my major reservation is not a legal one. That can be easily addressed. The real downside is relationship damage that can result when a well-intentioned helping hand comes up empty-handed when the loan comes due.

Let's start off by asking why the relatives wouldn't just go to a bank to get a loan. Do they hope to get a lower interest rate by borrowing from a family member? Or is it because they know a bank will consider them a bad risk? Remember: A banker has the perspective of experience at determining the creditworthiness of all types of people.

If you believe a relative is coming to you because professional lenders would reject the application, then be prepared to utter this phrase at some point: "I won't get my money back."

Complicating matters further, a bank is a business, first and foremost. But if you loan money to a relative, you're a lender second, but, more importantly, a family member first. It's a business relationship complicated by blood ties and emotions. If you need to press for repayment, you may discover that family ties weren't as strong as you thought. You may well be branded -- by the borrower or fellow family members -- as insensitive because you have so much more than they do. Or you might be told you really don't need the money right now, anyway. There is an expression that comes to mind: "No good deed goes unpunished."

Nevertheless, if you decide to lend money to family, it is much better to have a written agreement than just a handshake. For one thing, if things go wrong and you end up forgiving the debt, a good loan document will help convince the Internal Revenue Service that gift tax isn't due.

So let's see what might work best if you are determined to make that intrafamilial loan.

Hiring a lawyer experienced with these types of contracts would be good. The attorney will provide you with the best contract for the type of loan that you are considering. However, if you cannot afford to hire an attorney, or would just rather not, there are other resources.

You can use an online resource such as LendingKarma.com to purchase a standard loan agreement for a small fee. It can then be customized for your specific needs. Other websites, some for free, can help you create a loan agreement yourself. No matter how you press forward, I recommend having the loan terms in writing. Assure that both parties agree to, and clearly understand, the terms of the loan and repayment.

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Next, prepare a contingency plan for what happens if your family member defaults. Be sure to stress to the borrower what to do if they can't make a payment. Knowing that you will react in a certain way may help keep the lines of communication open when embarrassment at being late might otherwise short-circuit them.

Depending on the agreement, you may establish collateral for the loan. If so, you may at some point face the uncomfortable decision of whether to claim the collateral if your family member defaults.

If the loan is unsecured, then you must decide if you'd be prepared to file suit to recover the money. With a written loan agreement, you should have what you need to prove your case. But would you be willing to sue a family member? And don't forget: Even if you win, collecting the debt is still up to you.

In short, even with an agreement, the possibilities of hurt feelings, legal fees and all the other reasons that family loans are discouraged still exist. The bottom line, in my view: Only make the loan if you can afford to end up treating it as a gift.

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The Debt Adviser, Steve Bucci, is the author of "Credit Repair Kit for Dummies" and co-author of "Managing Your Money All-In-One for Dummies."

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