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A Loan to a Family Member

Q. My sister wants to borrow \$5,000. I have the money, but I'm not sure if I should do it. What should I consider and if I say yes, how should I do it?

— Lender maybe

A. It's sweet of you to consider helping, and it's great that you have the money on hand.

But still, you need to be sure the potential loss of \$5,000 isn't going to be a problem for you down the road.

Claudia Mott, a certified financial planner with Epona Financial Solutions in Basking Ridge, warns that you make sure if the money would be coming from your emergency fund that you have a way to replenish the balance.

Helping a family member should not jeopardize your own financial situation, she said.

You need to ask yourself if you will miss this money if it never gets repaid, Mott said.

"All too often, loans to family members aren't treated like an obligation owed a bank or other lender so regular and timely payments don't get made," she said.

Mott said it would also be important to discuss with your sister why she needs the loan to determine if there is another way to help get her out of the bind she is in. If the need for help becomes a recurring issue for her, she might want assistance with budgeting or may find working with a credit counselor beneficial.

If you decide that you are comfortable loaning the money to your sister, drafting a formal promissory note which you both sign would be important.

"Even though the amount is well below the federal gift exclusion of \$14,000, you want to be sure that the transfer to your sister is a loan and not a gift," Mott said.

The note should include the amount of the loan, repayment period, payment amount and interest rate. The IRS provides the applicable federal rate (AFR) on a monthly basis and can be used as a guideline.

"With the amount of the loan falling below \$10,000, it is not imperative to impute interest, but you may decide that it is important," Mott said. "You may also want to include a clause that describes what happens if the loan isn't repaid. Samples of promissory notes can be found on a variety of websites."

Where the money comes from is another consideration.

Mott said if you've got it stashed in a checking or savings account, then the transfer to your sister will be easy. But if you need to sell an investment to raise the cash, be aware of any capital gains or losses that might arise as a result. You may find it worthwhile to discuss your plans with your tax advisor to determine how to minimize the potential tax consequences, Mott said.

We're hoping you're not planning to take the cash from a retirement account like a 401(k) or an IRA.

The withdrawal would be considered taxable income to you and if you are under age 59 ½, would also carry a penalty, Mott said. As a matter of course, 20 percent is typically withheld for taxes, meaning you'd have to take out more than \$5,000 to net that after tax.

"Taking a loan against your 401(k) or using money from a home equity line of credit as sources of funds should also be options that are out of the running," Mott said. "Both are going to cost you money in terms of the interest you'll be paying."

If these are your only options, please think twice about making the loan to your sister.

Email your questions to ask@njmoneyhelp.com