Loan vs Gift: Making the Distribution Decision

Chances are good that at some point, you'll either give or loan a family member some money. If the sum is substantial, there's the question of whether to consider the funds a loan or a gift. Each uniquely impacts your financial planning and tax situation, so it's important to understand the financial differences between a gift and a loan.

SHOULD YOU GIVE A LOAN OR GIFT?

In the simplest terms, you expect to be paid back for a loan, while a gift bears no such expectation. You may give a child money for a car or tuition with the vague idea that one day they'll repay you, but in finance-speak, that's a gift. If you document the monies transferred with a contract and a repayment schedule, that's a loan.

Your individual financial picture determines how you account for the distribution, so you should know the basics of a gift versus a loan—the gift loan rules, when a loan is considered a gift, and whether a loan can be converted to a gift.

WHEN A GIFT IS THE BEST OPTION

Parents and grandparents who are thinking of giving (or lending) money to a family member are tempted to make the money an official loan on the theory that it will instill a sense of financial responsibility without the repercussions of money borrowed from a financial institution — most grandparents won't repossess a car or report missed payments to the credit bureau.

However, a formal loan document may create stress in the family. If the recipient skips payments or makes poor financial decisions, the grantor of the funds may feel justified in commenting on these choices. When this happens, the chances of the loan actually being repaid drop at least proportionally, resulting in more tension and a complete write-off of the money loaned.

Conversion of the Gift

The IRS requires that any family loan be treated like any other financial transaction—a written agreement, interest rate, and fixed repayment schedule. The interest rate on these loans is 3.35%, so it is an attractive option for the person needing the money—and is still in line with returns on deposit accounts, so it's not a bad deal for either party. However, should the recipient fail to pay back the loan, there are tax implications for both.

The lender can forgive the unpaid balance of the loan for up to $17,000 — this is called a gift loan.

The borrower may be responsible for taxes on the remaining unpaid interest. If the money was used as a private mortgage, then the rules are quite complicated, and you should consult both your financial advisor and CPA before you enter into a private mortgage.

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WHEN A LOAN MAKES MORE SENSE

Family tensions and other pitfalls aside, there are times when a loan is the better option. Lower interest rates, better loan terms, and tax advantages for the lender are all good reasons to formalize the transaction into a loan.

Basic Loan Parameters

A written document is critical. This document needs to establish the interest rate, repayment schedule, and asset exchange (cash, property, equities). There also needs to be a section that specifically addresses how the loan will be considered paid in full. Both parties will sign the document, and you should have it notarized. It does not have to be a complex document, but simply and clearly state the terms of the deal. Should the loan go sideways, this demonstrates the original intent.

Keep Records

Set up a spreadsheet to keep track of the loan repayments. Again, should the loan go into default, the paper (or digital) trail is a document the IRS will request.

Send Statements

Create regular statements for both parties' files. They can be issued monthly, quarterly, or annually—just be sure it's done. Statements should reflect principal and interest amortization, payments, and the outstanding balance. These statements are an additional layer of legitimacy for a family loan.

CONSULT YOUR FINANCIAL ADVISOR

Before you write a large check to a family member, consult with your advisor at Cary Street Partners for guidance. Understanding all the implications of giving money to a family member and how it impacts your financial future will help you make the right decision.