

Family Matters: Lending to Your Children

Have you ever considered lending money to your child for a down payment on a new home, to bankroll a business venture, or for some other large expense? Many adult children seek financial assistance from their parents if they encounter difficulty securing a bank loan due to lack of a credit history or collateral. For their part, many parents want to help their children succeed in life and are willing to give them a financial boost if they have the means. Though most parent-child loans do not go awry, if a loan does sour it can have serious consequences for unsuspecting parents. Here are four pointers to heed before lending funds to your child:

1. Document the Loan. If you expect the money to be repaid, consider treating the loan as seriously as a banker would by requiring the proper documentation. If you seal the deal with a handshake, and the business later fails, you must be able to convince the Internal Revenue Service (IRS) you made a bona fide loan in order to deduct it as a bad debt. To give yourself a sound basis for a tax write-off, request the following:

- a note and written loan agreement
- collateral or other form of security
- a repayment schedule and repayment records
- a plan indicating the loan will be repaid as scheduled
- if the funds are for a business loan, proof the business was solvent when the loan was made

Proper documentation can also help you avoid other complications. For instance, if your child were to divorce, a written loan agreement identifying who is responsible for repayment, and on what terms, could prevent a former spouse from refusing responsibility for the debt or claiming the money was a gift. It could also keep an ex-spouse from obtaining-through the division of marital assets³/₄ a controlling interest in a company you funded.

2. Know the Rules. The IRS allows you to deduct bad debts only after you have tried to collect them, by legal means, if necessary. So if you want to write off the loan, you must be prepared to take legal action to collect it.

If, after taking legal action, you're still unable to collect the loan, you may write it off as a short-term capital loss by subtracting the outstanding loan balance from your total short- and long-term capital gain for the year. If the loss exceeds your total capital gain, you may deduct it in \$3,000 increments each year until it is entirely written off.

3. Treat the Bad Debt as a Gift. Instead of a lawsuit, you may have the alternative of treating the bad debt as a gift. In 2006, the IRS allows each taxpayer to give up to \$12,000 per person per year free of gift and estate taxes. Thus, both parents together could offset an uncollectable debt with a combined gift of up to \$24,000 per year with no tax consequences. (Any amount exceeding this limit may be subject to gift and estate taxes.)

4. Use Common Sense. Lending money to a child may have certain tax consequences for you, and it's important to be prepared. Consider the odds of a successful follow-through on your child's part. Think twice before lending money for a risky venture unless you are willing to part with it as a gift with possible tax consequences, if need be.

Supporting a child's dream can be an exciting and rewarding experience for a parent. However, pay attention to potential tax traps and legal pitfalls before opening your checkbook and seek professional advice.

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