■ FINANCES

Giving a Helping Hand

Experts say it's risky, but when done right, a loan between family members can benefit everyone

By KAREN BANNAN

WHEN FOUR OF ROGER JUSSEAUME'S nieces and nephews bought new homes last year, they didn't go through a bank or other institution for financing. Instead, Jusseaume, an Arizona entrepreneur, was more than happy to lend them the money. While few relatives can afford to be that generous—after all, there aren't many people who have the means to provide $500,000 worth of mortgages—loans between family members are common. Financial planners and family counselors often caution against the practice, but the Federal Reserve estimates that 2.1 million U.S. households owe money to individuals, including friends and family members. These loans may seem appealing, since they cut out the application process and give fast access to cash, but they come with plenty of risks for both the lender and the borrower. Credit counselors say many personal loans between family members go unrepaid, which can lead to anger and unraveling of close ties. And even when loans are repaid, they can create an unsettling change in the balance of power between relatives. That may be less of a problem between parents and children, but it can devastate sibling relationships.

"The person who borrowed becomes more vulnerable and feels less than the person they have borrowed the money from," says Kathleen Gurney, founder and CEO of Financial Psychology Corp., a consulting company based in Sarasota, Fla. "It's not a level playing field anymore." Resentment and guilt can build up, threatening even the deepest of bonds.

Toni Goldfarb, a writer in Old Tappan, N.J., says a five-figure loan she made to a close family member upset their relationship, even though they had a signed agreement and he was paying interest on the sum. The problem was both the repayment schedule—she says her relative paid her quarterly in "dribs and drabs"—and the fact that he lived a more affluent lifestyle than she and her husband did. It took more than five years for Goldfarb to be fully repaid. "He didn't think this was a big deal because he thought it was a fair exchange," says Goldfarb. "He was paying me a fair interest rate. He sees it as a success story, whereas I still have negative feelings about the whole thing." Nonetheless, she says, she would lend her family member money again without hesitation.

Emotional issues aren't the only reason to think twice about family loans. There can be financial consequences too. Borrowers—especially those with limited credit histories—miss out on the chance to build their credit rating when they borrow money privately. This can be a hindrance for them later in life when they apply for a car or home loan.

Lenders, of course, lose access to, and often interest on, their money. But there can be other costs as well. For exam-

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ple, unless lenders charge interest on their loans at the prevailing market rate, they may be liable for the difference if they're audited, says Brent Neiser, director of collaborative programs at the National Endowment for Financial Education. And if they fail to charge any interest at all and

don't set repayment terms, the loan can be considered a gift that is subject to IRS gift-tax rules. Depending on the sum, the tax can run as high as 50%.

Many lenders commit what experts say is the biggest error: borrowing money from a credit card or bank on someone else's behalf. If the borrower stops making payments, the person who signed, or even co-signed, for the loan has to make good on the debt. "We have seen with some frequency individuals who are left holding the debt for someone else's mistake," says Joel Greenberg, president and CEO of Garden State Consumer Credit Counseling Inc., a nonprofit financial-counseling service in Freehold, N.J. "It's a story that never goes away and happens very, very often to our clients."

But if, despite all these cautions, you're still considering a family loan, there are things you can do to avoid pitfalls, experts say. One of the newest options is to contract with a loan-servicing company. That's what Roger Jusseaume did. Seeking to protect his significant investment, he hired CircleLending, based in Cambridge, Mass., to manage the loans he gave his nieces and nephews. "I looked at what the company offered and decided it would be a great way to protect both sides," he explains.

CircleLending charges a small set-up fee and a percentage of the original loan amount for its services and handles every aspect of the lending experience, from drawing up formal promissory notes to collecting payments each month. Asheesh Advani, the company's president and CEO, says his firm has facilitated more than $2 million in loans since it was launched in May 2000.

Those who don't want to be confined by such a formal agreement can still benefit from drawing up a legal document on their own. These agreements should include such payment terms and conditions as the interest rate, repayment schedule and consequences for late payments. "Unless you have a legal docu-

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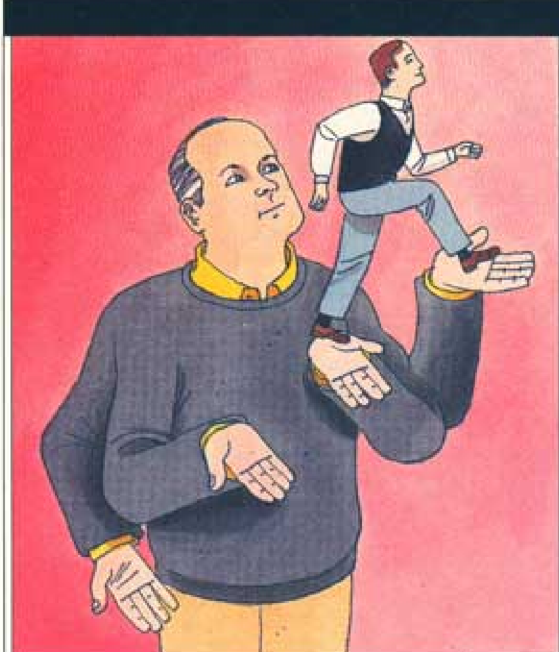

ment, it's very hard to force an issue and recoup money lent to family members," says Garden State's Greenberg. "You should never lend money without some form of written document and the understanding that the person has the means and ability to repay you."

STILL, THERE IS ONE STEP THAT should come even before any legal documentation: emotional accounting. Financial Psychology Corp.'s Gurney cautions her clients that they should have a face-to-face meeting to discuss their feelings about such a loan. "If you have to borrow or lend, you have to take the emotions out right away and make it a business deal," says Gurney. "Everything has to be put on the table, including fears, trepidation, the risks involved. How people deal with those initial feelings really speaks to whether a loan is going to work out well in the end."

Gurney says such discussions should include what the borrower will use the money for, since one family member's necessity may be another's frivolity. She also advises lenders to ask themselves if they can emotionally and financially afford to lose the money involved. Finally, lenders should prepare for the possibility that news about their generosity will reach other family members and breed resentment or trigger requests for additional loans.

Of course, not every family loan is a disaster. In the best of circumstances, such transactions can benefit everyone involved. "If all goes well, then it's a win-win situation," says Gurney. "You've helped a family member, and they've proved their trustworthiness. Still, you should go into any of these loans with your eyes wide open. The primary currency in a family is love and support. When you lend money, you're risking losing these."

Jusseaume says his lending experience has brought him closer to his family. "If a loan is handled in a businesslike fashion with a real spirit of giving, only good can come of it," he says. "My nieces and nephews are extremely appreciative, and they're finally in a position where they don't have to worry about saving for a down payment." They also know they have family they can count on. ■