

Loans to Family Members (or is it a gift...?)

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Parents enjoy helping their children by “lending” money to buy a house or help children in times of financial stress. Often the terms of this “loan” are unclear. The child may see it as a gift and yet the parent expects return of the money in the future. There are at least two situations when the terms of this “loan” become important. The first is when child gets divorced. In that situation the parent will often claim that it is a loan so that the money will not be divided as matrimonial property with the son or daughter in law. The second situation is when the parents die and it must be determined whether the child must repay the “loan” as part of his or her share of the estate. There are some important tips to consider for each of these situations.

The Matrimonial Breakdown.

If a parent wants to ensure that in the event of a divorce the money lent to a child will not be simply divided with the errant son or daughter-in-law, then it is important to document the loan. The child should sign a promissory note. The note will state the amount borrowed, state the interest rate (if any) and will determine when the loan is repayable. The promissory note can be secured with a mortgage against the child’s house. Usually, there are no repayment terms, in that case, the loan will be said to be payable “on demand”. Thus the loan will only have to be repaid when the parents request repayment. The parents may decide never to ask for repayment or can ask for repayment with interest if there is a divorce. It may seem odd to document assistance to your children. However, if you do not document it, you risk having your philandering son-in-law make off with half the money you gave your daughter to buy a house.

Death of a Parent

It is important for parents to deal with whether loans to children are to be forgiven or to be collected from the child on the death of the parent. In respect of collection, the loan does not really need to be collected, the child can take the loan amount as part of their share of the estate. It can essentially be treated as an advance on inheritance.

Either way, the parent must make it clear in their will, or risk having problems, when the executor is administering the estate. If you take the first advice given above, you will have

documented the loan. Most wills have a general provision that says the executor should collect all assets of the estate. If there is an outstanding promissory note owing by a child, the executor will be obligated to demand repayment. The child may argue that the loan was not meant to be repaid except in the case of a divorce. It is unclear who would win this disagreement but one thing is certain, parents should not leave this uncertainty on their death.

A parent should clearly stipulate in their will what should occur on their death. There are basically three options:

1. The loan can be completely forgiven. In this case, the child takes the funds and need not repay them and then will still receive an equal share of the estate. If all children have borrowed equally or if there is no need to absolutely keep payments to children equal, this is a good solution.
2. The loan amount can be considered part of the child's share of the estate and thus the child will receive a smaller share of the estate as the child will be treated as having received the loan as an advance on his or her inheritance. This is a good solution where all children are to be treated equally and there are ample funds in the estate to give each child an equal share of the estate without repayment of the loan.
3. The child can be asked to repay the loan to the estate. This is a good solution where all children are to be treated equally but there are insufficient funds in the estate to pay an equal share unless the child repays the loan.

Certainly, any combination of these solutions can be used. Part of the loan can be forgiven and the remainder repaid. Part of the loan can be taken as part of the child's inheritance and the remainder repaid.

While loans to children may not seem troublesome when they are made and while the parent is alive, as soon as a divorce or death occurs, everyone will have wished that the parent had been diligent and documented the loan and their intentions for repayment. No parent should leave their children in the situation where the children may have to go to court to determine if the loan was a "loan" or a "gift".

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