

Thinking About Borrowing from Family or Friends? Do It The Right Way

Whether it's for a business, a home or a new car, there's something very attractive about the idea of asking friends or family for a loan. Nobody's worried about a credit check or the other lengthy documentation and you can still hang out with your lenders at the holidays.

In 2005, the National Association of Realtors reported that about 9 percent of first-time homebuyers made their purchase with help from a friend or relative, up from 5 percent in 1999. About 25 percent of new homebuyers get money from a relative or friend, a portion that's remained fairly constant over the past decade.

Yet there are good and bad aspects to private loans. The good news first:

- Terms can be significantly friendlier than a borrower would qualify for in the open market. For example, the rate charged on the loan can be higher than the lender would receive in a deposit account but lower than the borrower would pay a commercial lender.
- They can require little or no collateral.
- It's a way to keep money in the family.
- It's a way for a borrower to be able to buy a home, a car or other critical assets even if they have a poor credit rating.
- There's no loss of tax benefits to the borrower or lender if an agreement in the case of a mortgage loan is structured and reported properly.

Then the bad news:

- Unclear agreements can lead to missed payments or default.
- If the borrower dies suddenly, the lender's investment may be lost if the agreement isn't structured correctly. A properly executed promissory note is still an obligation of the estate, and may continue to be paid to an heir or other person or entity based on the terms as agreed.
- Jealous relatives could say they weren't treated fairly.
- Disagreements between borrower and lender could kill an important relationship.

The best arrangements are formal – written in proper legal language, notarized and recorded in the county where the property resides. A financial adviser can talk to both parties about what such loans – particularly real estate loans – can mean for their respective finances. It also makes sense for both parties to visit their respective tax professionals to make sure they know the correct ways to document the loan transaction over time for tax purposes.

A detailed document – prepared with the help of an attorney – can also lay out specific scenarios if either the borrower or the lender has to break or alter their agreement. Such trained experts can talk you through the benefits and pitfalls of a private loan arrangement as it affects your particular situation (either as lender or borrower) and specific laws and requirements in your state you have to follow if both borrower and lender are going to derive tax advantages from the agreement.

Generally, any private loan transaction should include a promissory note that establishes how the debt will be repaid. That's true for business loans or loans for most types of property. In the case of a business loan, it makes sense for the potential borrower to get specific advice on how lenders in their business will be treated not only in terms of repayment, but default.

In the case of a loan made for real estate, a mortgage or "deed of trust" statement (depending on the state you live in) or an agreement specific to the type of loan that binds the property as collateral for the promissory note will be necessary. It basically says that if you don't fulfill all the terms in the agreement the lender has the right to foreclose or repossess the property.

Even if a friend or relative makes an offer of help, it's proper for the borrower to take the initiative to structure the arrangement in a way that's responsible and beneficial to both. If a relative is drawing income from the loan, special provisions should be made for prepayment and other contingencies.

The most important thing to remember and plan for? When two people who are close to each other enter into such an arrangement, the most valuable thing really isn't the money. It's the relationship.

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