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Use Promissory Notes when Lending to Family and Friends

Loaning money to family and friends can be a delicate subject, so always protect yourself by putting the terms of the loan in writing. Promissory notes are documents that contain the terms of a loan so that there is a legally actionable record of the loan specifics.

If your friends and family take offense at the suggestion that you create a promissory note, an easy way to justify it is to explain that the loans can have tax consequences and you simply need a written record in case the IRS ever audits you.

The Basic Terms of Promissory Notes

There are really only three very basic things that need to be in promissory notes, and keeping it simple can help alleviate any fears that friends or family may have about signing the note. The three things to include in promissory notes are:

- The amount of the loan
- How and when the loan will be repaid
- Whether, and how much, you will charge for interest

Optionally, you may also choose to secure the loan with property (for example, you could use a friend's car as collateral). This makes the agreement more complex, but if you do choose to secure the loan with property here are some guidelines:

- **Personal property:** Personal property comes in two flavors, tangible and intangible. Tangible personal property is essentially someone's "stuff", such as a car, a computer or a piece of jewelry. In addition to the promissory note, you need to create a security agreement establishing the parties' respective rights to the piece of property. Intangible personal property includes things such as patents, copyrights, trademarks as well as ownership rights in a business. If you plan on using intangible personal property to secure a loan, you will need a lawyer to draft such an agreement.
- **Real property:** Real property typically refers to things such as your house and any land you own. Real estate agreements require mortgages or deeds, and you should hire a lawyer to draft any such agreement.

How and When the Loan will be Repaid

Most people follow one of two ways to repay a promissory loan. Remember to keep it simple and keep it concise:

- **Paying in a Lump Sum:** Probably the easiest form of repayment is to pay it all back in one lump sum. If you choose to go this route, specify the date that repayment is expected, and whether that lump sum includes any interest owed as well.
- **Paying in Installments:** The other common form of repayment is to simply set up a way for the borrower to pay back the loan in installments. Typically, installments will be monthly or yearly. If you are charging interest, make sure to apply part of each payment towards the interest owed.

You could also structure a balloon payment system, but this isn't recommended because of complexity. A balloon payment is a hybrid between paying in installments and a lump sum, where the borrower pays in installments up to a certain point at which time they owe the remainder of the loan in a final lump sum payment.

Whether You Should Charge Interest

It may feel wrong to even consider charging family or friends interest, but if you don't, you're essentially giving them a gift. One of the roles of interest is to maintain the value of the money against inflation. One-thousand dollars today is not the same as one-thousand dollars five years from now, so charging a modest amount of interest shouldn't bother the lender or borrower very much. Be aware that your state does have limits on how much interest you can charge (commonly called usury laws). Usually rates over 15-20% will be prohibited in your state, but hopefully you aren't charging your family and

friends that much anyway.

The IRS and Interest-Free Loans

If you decide to give the loan without charging any interest, be prepared to justify it to the IRS, because it literally is a gift in the IRS's eyes. The IRS can "impute" interest on your loan, whether you actually charged any interest or not, and require you to report that imputed interest as income. Fortunately, for most small personal loans this can be avoided because the imputed interest can be treated as a tax-free gift provided that the total amount is less than the limit for gift-tax exclusion.

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