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Borrowing From Friends And Family: 5 Things You Need To Know

The Huffington Post/AOL Small Business [Geoff Williams](#) First Posted: 7/19/10 04:33 PM ET Updated: 8/5/11 04:44 PM ET

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For a lot of startups, money is tough to come by. So it's not surprising that many fledgling entrepreneurs think about borrowing from the Bank of Mom and Dad or floating their business plans by college buddies. In fact, borrowing money from friends and family is the most common method for raising startup capital.

But getting a business loan from your friends and family can't help but become personal -- and there are countless horror stories out there to prove it. That said, there are also plenty of successful entrepreneurial stories that begin with conversations at the Thanksgiving table or the local bar. How can you approach this tricky topic and ensure that your personal relationships do not suffer? Here are five things you need to know.

1. Money will impact your relationships.

Not that you haven't considered that. But it's worth really thinking this through. If you can't pay back the money your friends or family loan you, or if you take it and then don't communicate with them, you could lose your relationship. And while you may be right if you're thinking, "Mom would never disown me," or, "Chuck and I have been friends since third grade," the respect they have for you could take a hit. "Make sure that this loan doesn't put the family member or friend in a hardship," urges Lisa Baskfield, a member of the [American Institute of Certified Public Accounts'](#) National CPA Financial Literacy Commission. "It's similar to investing in the market. The person loaning the money should be okay with the idea of losing all funds."

2. Treat this as a business relationship.

Jeffrey L. Yount's advice seems right on the mark. "Treat this transaction as a normal business transaction," advises Yount, a partner at [B2B CFO](#), which provides CFO services for emerging and mid-market companies. "That's what it is. Don't have an attitude that implies, 'These are my friends and family. They will understand if I miss or delay a monthly payment, or fail to provide timely financial information or fail to communicate financial issues.'" At the same time, Yount says, "This is your business. Don't let the friends and family interfere with the day-to-day operations. Remember, they have only provided some financing -- they are not co-owners."

3. If the loan is more than \$10,000, enlist an accountant.


Mitchell Freedman, who owns the [Mitchell Freedman Accountancy Corporation](#) in Westlake Village, Calif., correctly observes that many family and friends don't want to charge borrower interest to their relative or pal who is starting up a business. But they may have to. "If the loan is for more than \$10,000, the lender is required by tax law to charge interest on the loan, even if her or she doesn't want to," Freedman says. "If there is no interest, then OID [Original Issue Discount] effectively reduces the amount of the loan and requires the lender to pick up a portion of the repayment as interest income. The IRS issues monthly minimum interest rates that must be charged, called AFR [Applicable Federal Rate]." In other words, if the loan is more than \$10,000, thank your friend or family member profusely -- and then consult a tax accountant or attorney.

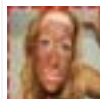
4. Put everything in writing.

That may sound obvious, but we would be remiss if we didn't stress it. All of the terms -- how much the loan is, when it's going to be paid back, what the interest rate will be if there is one -- should be put down on paper. Freedman adds that if there's any collateral you plan on giving your friends and family if the loan isn't paid back, put that down, too.

Gail Cunningham, a spokeswoman for the [National Foundation for Credit Counseling](#), suggests explaining what will happen to the loan if you die. "Will the loan be forgiven, or will it still be owed?" she asks.

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Now, of course, if we're just talking a loan for a few hundred dollars, the stakes aren't as high. Plus, these are your friends and family we're talking about. Chances are, if you somehow perish before your company is moving along, and you leave some friends and family in the financial lurch, they won't shake down your spouse, kids or elderly parents for the rest of what you owe them. On the other hand, you never know. The more money you borrow, the more of these questions you should ask.

5. Be realistic.

Baskfield urges realism on payment terms and warns, "Don't make false promises." Because they're your friends and family, you may feel the urge to dazzle them with suggestions that they're all going to become rich, fast. But starting a business can be extremely challenging, and this is a tough economy. When you're borrowing from friends and family, if you can, under-promise and over-deliver. But above all, when structuring your repayments, pad in some extra time for unexpected problems -- like having your own clients or vendors dragging their feet in paying you back.

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