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CONSUMER BANKING

Lending to family? Get it in writing**Loans between family members can raise more problems than they solve**

By Gail Liberman and Alan Lavine

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PALM BEACH GARDENS (Fla.) – With bank credit still tight, many seek to borrow from family as a last resort.

At Virgin Money USA, the volume of "social loans" -- loans between people who know each other -- has doubled to \$400 million since October 2007. The Waltham, Mass.-based company said loans arranged for family members are 53% of its social loans.

Video: Fed may regulate overdraft fees

The Fed is debating whether reign in pesky overdraft banking fees. WSJ's Kelsey Hubbard speaks to WSJ reporter Kelly Evans about whether consumers will really benefit.

But not all family lenders are happy campers. Just ask actor Richard Dreyfuss, who is embroiled in a family loan dispute in Los Angeles Superior Court.

While bankers often seek to keep loan delinquency ratios under 2%, Virgin Money estimates that nearly 5% of its family loans are delinquent.

Most experts agree that borrowing from a family member can prove tougher than borrowing from a bank in more ways than one.

"When people make loans to each other, they tend to be undocumented," said Robert F. Klueger, an asset-protection and tax attorney with Klueger & Stein LLP in Los Angeles.

Plus, he says, family members often don't think they need a security interest in a relative's home. These issues, respectively, can make a family loan harder to document in court and harder to collect.

If you're a lender trying to collect on a defaulted loan, the borrower has little defense if you can document that there is a promissory note and you gave "consideration," such as money, for it, Klueger said.

However, a promissory note merely is a promise to pay. If you expect to collect, consider what security is being offered. "If your son wants money to open a dry cleaning store and there are no accounts receivable, that dry cleaning store likely won't be worth anything if [your loan] goes into default," he said. If you take security in his home, you may have to foreclose if the loan isn't paid. Foreclosure is not easy.

Any promissory note, Klueger said, should provide for the payment of costs and attorney fees to the prevailing party. It should have a default or higher interest rate to discourage late payments. Any default rate also must consider state "usury" laws, limiting credit interest. "Some will prevent you from not only collecting the higher rate, but they might actually result in the forfeiture of all interest and principal," Klueger said.

Watch for a tax hit

There also may be tax consequences on family loans. If you're the lender on a personal loan, you needn't worry if your loan to a relative is \$10,000 or less, said Tom Ochenschlager, vice president of taxation for the American Institute of Certified Public Accountants in Washington. Nor need you worry if the family loan is less than \$100,000 and the borrower has no investment income.

However, to avert tax shenanigans, the IRS sets minimum interest rate thresholds on family loans that exceed \$100,000. If your family's loan interest rate fails to exceed those thresholds, ranging in April from 0.83% on loans to three years to 3.67% on loans over nine years, the lender could owe more taxes. To find IRS thresholds, enter the words "applicable federal rates" in the IRS search engine at IRS.gov.

If your family loan is over \$10,000, but less than \$100,000, the interest charged generally is not required to exceed the amount of the borrower's investment income.

Be sure your loan is well-documented with a promissory note to avert an IRS argument that it's an outright gift, subject to tax rules which kick in on gifts of more than \$13,000, Ochenschlager said.

The good news is if the loan defaults, the lender can declare a short-term capital loss to offset against short-term capital gains and up to \$3,000 in income.

If you're the borrower, and the loan is for your primary residence, you may be able to deduct mortgage interest on your

income taxes if the lender registers as a "secured property owner" at a jurisdictional courthouse.

Ask questions

Virgin Money claims to avert many family loan headaches by charging \$99 to \$699 per loan and a transaction fee of \$9 per loan payment to arrange loans among family and friends.

If the borrower is delinquent, the company emails the borrower and follows up with a phone call, suggesting ways to get back on track. If the borrower is unresponsive, the lender decides if and how to proceed. Options may include collections, reporting the default to credit bureaus, forgiving it or continuing to hope the borrower responds.

The critical question to ask before issuing a family loan: "Will the financial contribution help solve a problem or will it feed a destructive and motivation-stifling behavior," said Brad Klontz, financial psychologist and coauthor of "Wired for Wealth."

To avoid hurting or insulting a family member, he suggests letting an objective third party -- such as your financial planner -- make the call on issuing a family loan.

Before making the loan, consider the worst-case-scenario, he said. That means answering the following questions:

- What will you do if he or she cannot repay?
- What will you do when other family members hear about it and ask you for loans?
- What if you disagree with a purchase, like a vacation, financed by your loan?

Spouses *Gail Liberman* and *Alan Lavine* are syndicated columnists. Their latest book is "*Quick Steps to Financial Stability*" (Que/Penguin). You can contact them at www.moneycouple.com. ■

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