

“Can you give me some seed money for my business?”

Let's say your brother-in-law is starting a new business. You listen to his idea, read his business plan and think the endeavor sounds promising. Your brother-in-law asks if he can have \$20,000 to help get the business off the ground.

Should you just pull out your checkbook and shake hands?

You may think that a casual agreement to help out a family member or friend is enough. After all, you *trust* the person and want to help the start-up company succeed.

Do yourself a favor and take these steps:

1. Don't agree immediately. Tell the family member or friend you'll think about it. Take time to review the request and the business.

2. Get the agreement in writing. In the future, you may have a disagreement or forget the exact terms of the deal. Your brother-in-law may think the \$20,000 is a gift while you consider it a loan.

If you're uncomfortable asking for a written agreement, tell the potential borrower that your attorney or accountant insists on it.

3. Examine the best way to structure the transaction. When putting up seed money for a start-up company, you have to decide whether the amount is a gift, loan or equity investment.

When Debts Go Bad

What happens if you lend a friend or relative money with a promissory note and the individual never pays you back? Just like any creditor, you can make attempts to collect the debt. For example, your lawyer can send a demand letter. If there is collateral on a secured loan, you can take steps to collect the property or you can start a lawsuit.

As a last resort, you might get a tax break for a bad debt in the year it becomes worthless — if you first make attempts to collect. Documentation is key. Consult with your tax advisor for more information.

Gift versus Loan versus Equity

Here are the three basic options for transferring a substantial amount of money to a friend or family member:

1. Gift. You can simply give someone money with no strings attached. However, under the tax laws, you can only give \$14,000 a year to an individual with no gift tax consequences. If you are married, your spouse can also give \$14,000 annually to the same person, so together, you can give up to \$28,000 during the year.

If you decide to just give money to friend or relative, you should also give the person a letter explaining that the amount is a gift. Keep a copy. That way, if the IRS claims the money is an interest-free loan, you have documentation.

2. Loan. Create a document, called a promissory note, that states:

- The amount of the loan;
- What interest rate will be charged;
- How the debt will be repaid; and
- Whether there will be penalties for late payments.

Give the borrower time to review the promissory note and confer with an attorney before signing. Be sure that both parties understand the terms.

Should you charge an interest rate? If you don't, the IRS could deem the loan a gift or the "below-market loan rules" could come into play and create unexpected tax consequences. Charging the "applicable federal rate" (AFR) satisfies the IRS when it comes to private lending. Fortunately, the AFR rates are low compared with rates charged by commercial lenders. So the borrower gets a good deal and you avoid complex tax rules.

AFRs are updated each month in response to bond market conditions.

Other loan tax implications: As a lender, you report as taxable income the interest received. On the other side of the deal, the borrower can deduct the business interest expense.

3. Equity investment. When you provide money as equity in a business, you become a shareholder or part-owner. That means that you take on the risks of the business. There is no guarantee that the enterprise will make money. If it fails, you lose your investment. On the other hand, with a loan, the borrower would still be expected to be pay you back even if the business fails.

An equity investment may also give you a voice in the business, which you may or may not want. If you go this route, be aware that the company must comply with federal and state securities laws. You must have full disclosure of all risks involved. The company may need to register its issuance of securities with the SEC. However, it may be exempt from SEC registration requirements.

Of course, even if you give a gift or loan, you should have full disclosure about the business.

As with the other options, the terms of an equity investment should be in writing. Consult with your attorney for the specifics that should be included in the legal document.

Conclusion: Shakespeare wrote that "Neither a borrower nor a lender be" because you will lose the money and the friend. A personal loan to a relative or friend could strain or even ruin the relationship. Keeping the transaction as professional as possible can help preserve your financial outlay as well as friendships and family bonds.

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