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Leading EDGE

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ADVICE & INFORMATION TO HELP YOU MANAGE YOUR BUSINESS

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Sources of Capital For a Growing Business

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The growth stage of a privately-held business can include any number of activities, including new product development, purchase of new machinery and equipment, expansion of an existing facility, opening of a new facility, or even the acquisition of another business. The common denominator among all of these is the significant investment of capital required to successfully accomplish them. Of course, for most businesses, the capital available to deploy on the expansion project is generally limited.

So where can a business obtain the additional capital needed to fund its growth plans? The following are some sources of externally-derived funding available to privately-held companies:

Commercial banks – Likely the most common source of capital is debt financing obtained from a commercial bank. This can take the form of short-term working capital loans or longer duration term loans collateralized by some of the company's assets.

Depending on the strength of the company's financial position and/or its relationship with its current bank, the company often needs only to ask its lender for the additional loan or increase in credit facility, especially in today's low interest, high credit availability environment.

Commercial finance companies – These non-bank lenders provide long-term debt financing similar to that of banks, and are often interested in specific projects such as equipment purchases or long-term plant expansions.

Factoring – Another form of non-bank financing, a factor provides a company with an advance on its accounts receivable, with the balance less a discount or fee paid upon collection of the receivable from the customer. In effect, the company receives most of the cash from a sales transaction almost immediately, improving its working capital position and ability to fund other projects.

Investment banks – If the current ownership is willing to relinquish some of its control in exchange for a capital infusion for the company, investment banks can assist with a private placement of equity. In such a transaction, the investment bank locates institutional or individual investors who purchase equity in the company in a privately-arranged deal.

Some potential sources of funding can actually be derived from the resources of the business. They include:

Retained earnings – A business can look internally to its own stockholders' equity. By foregoing or reducing the payment of a dividend or distribution, the owners are leaving money in the business to be reinvested.

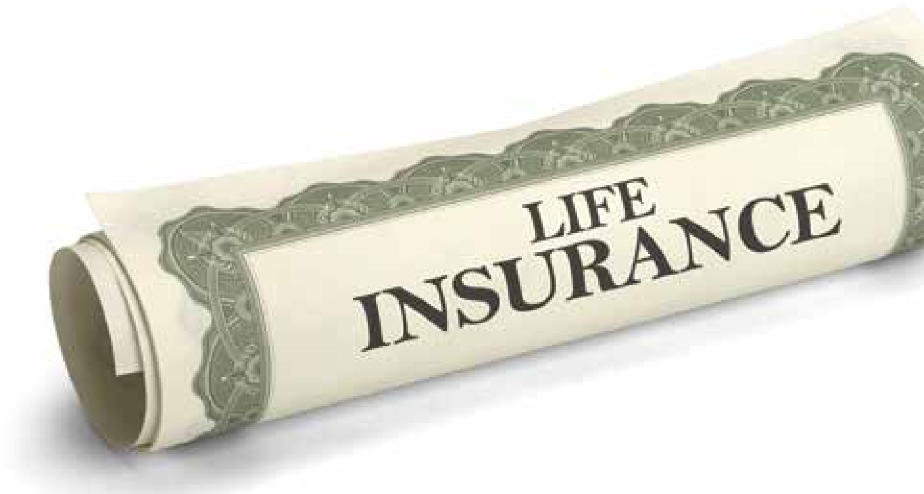
Employees – A company can consider setting up an employee stock ownership plan (ESOP). Through an ESOP, employees can purchase shares in the company, or receive them as compensation, both of which improves the cash position of the company and provides equity financing. Added benefits of the ESOP are the production efficiencies often experienced by businesses that are employee-owned, as well as the overall pride felt within the organization.

Suppliers – Extending the terms on the amounts owed to suppliers – for example, from 30 days to 60 days – may provide the temporary boost in capital needed for a project.

Lastly, here are a few additional sources of capital that a growing company can consider:

Federal, state and local agencies – There are loan programs run by the U.S. Small Business Administration and various state and local economic development offices that may be available to companies that meet certain criteria.

Peer-to-peer lending – A relatively new kid on the block, peer-to-peer lending is an online source of crowdfunding that continues to gain in popularity. While it may not be a practical solution right now due to project size limits and other restrictions, the concept doesn't seem to be going away any time soon. It may be worth keeping an eye on crowdfunding for future developments or refinements that might make it a more viable alternative. **LE**



Using Life Insurance in Closely-Held Companies

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It is important for individual shareholders in closely-held companies to plan for future liquidity needs, which may include funding buy-sell agreements, paying estate taxes (family succession planning), and "key man" coverage for the owner or other valuable company executives. Life insurance can be an effective way to plan for these needs.

Funding buy-sell agreements via life insurance policies can be achieved by the co-owners purchasing policies on the life of the other co-owner(s). The beneficiary of the policy must be the co-owner purchasing the policy. Upon the death of a co-owner, the beneficiary would be permitted to use the policy's proceeds to purchase the deceased co-owner's stock. The buy-sell agreement usually states the valuation of the stock purchase price in the agreement. One issue with the cross-insurance arrangement, however, is that the insurance premiums are paid by the co-owners personally, rather than by the company.

Another method of funding a buy-sell agreement would be to have the company take out policies on the co-owners. Upon the death of a co-owner, the company would redeem his or her stock. This method allows the premiums and purchase price to come from corporate funds, rather than personal funds. However, the insurance premiums would not be deductible by the company and depending on the type of entity, there can be different tax traps by having the company as the beneficiary.

If ownership will not transfer via a purchase but rather an inheritance, the current owner may want to provide funds for a beneficiary to be able to continue the company. The cost of estate and inheritance taxes may cause the company to be sold if there is no cash to pay for these taxes.

If the company stock is inherited by family of the sole or controlling owner, then split-dollar life insurance policies can be used to assist in paying the estate taxes. This allows the company to loan money to the owner for the payments of the premiums. There is interest that needs to be paid on the amount of the loan or imputed into the employee's wages with the arrangement.

Upon the death of the owner, the company receives an amount equal to the cumulative premium payments with the balance of the policy payable to a personal beneficiary of the owner. The payment of the policy directly to the personal beneficiary removes the life insurance from the owner's estate and assists the beneficiary in paying the estate and inheritances taxes.

Many businesses are dependent on owners or other key executives and the unexpected death of a key person can have a traumatic effect on the operation of the business. Therefore, the use of life insurance proceeds can be critical to the continued success of the company. Life insurance is owned and payable to the company to support the replacement of the key person.

A split-dollar arrangement may also be used to fund key-man life insurance. In this case, the key person would own the policy and the company would receive the death benefit. If the employee survives until retirement, the company would no longer require the life insurance policy and could relinquish its rights to the policy.

These are just some of the life insurance planning options available. The rules of the Internal Revenue Code and Regulations can be complex and if they are not followed properly, unintended problems may arise. It is important to have tax accounting, legal, and financial advice to structure these transactions properly. **LE**

Using Private Annuities in Family Businesses

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In general, a private annuity is a transaction between two parties where neither is an insurance company. There may be several reasons to set up a private annuity. This article will focus on private annuities as an estate planning tool for closely-held business owners who would like to sell their businesses.

In essence, a private annuity is a deferred payment sale and involves a taxable transaction. There are three types: a life annuity, a stated term annuity, or a maximum payout amount.

The life annuity is the most prevalent. A life annuity payment usually stops at the death of the seller, but it may also cover the seller's spouse.

When a closely-held business owner would like to retire and needs additional funds for retirement, using a private annuity has merit, especially if one of the buyers is from the next generation and already works for the company. It would also apply for key executives who are not family members but are interested in purchasing the business.

The business owner could sell his or her ownership interest to the buyer in exchange for a private annuity. The annuity income payout is based on the fair market value of the entity and the applicable Internal Revenue

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Service annuity tables and rules are used to determine the payment amounts. The payments are generally higher over the payment period versus an outright installment sale. If the annuitant outlives his life expectancy, the purchaser must continue to make payment for the life of the annuitant or until the agreed upon payout is made.

How is the private annuity taxed? The transaction shifts the future appreciation of the business to the purchaser and out of the seller's estate for federal estate and most state death taxes. Each payment received by the annuitant has, in part, a tax free return of basis, a capital gain portion, and a portion as ordinary income. Once the annuitant (seller) recovers his sale price, the remaining payments are subject to ordinary income tax rates.

A member of the DuPont family is frequently used to illustrate private annuities. A DuPont transferred property with a fair market value of $13 million to a family-controlled holding company in exchange for payments to himself and his spouse for $900,000 until the death of the survivor. Mr. DuPont lived another 30 years, far beyond his life expectancy, and received $27 million. By the time of his death, the value of the transferred property was more than $500 million and Mr. DuPont was successful in removing hundreds of millions of dollars from his estate.

It must be mentioned that IRS regulations limit the use of their tables mentioned above if the transferor suffers from a terminal illness. A transferor having general infirmities, but not from a specific incurable life-threatening illness, is not deemed to be terminally ill under the rules. The IRS may rebut this, but only by showing clear and convincing evidence. If the IRS cannot show this and the transferor survives 18 months and one day, then the transferor has successfully reduced his estate.

In sum, private annuities are a tool that should be considered in the buyout of a business interest. The major advantages are estate tax savings and a possible lifetime income stream to the transferor. However, the transferee has a number of potential risks. None of the payments can be deducted as interest. There is a risk that the property purchased will not produce sufficient income to meet the annuity payments. And the major risk is that the transferor will live longer than his or her life expectancy. **LE**

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