

# Trendlines



*New Directions in Business and Personal Planning*

## Thinking outside the bank

Alternative sources of business financing

## Have more to lose? Leave less to chance

Estate planning options for business owners

It's never too late  
to learn more about college funding

## Plus!

**Moneylines: News briefs for businesses and individuals**

*Nest eggs grew in 2003,  
IDITs become more powerful ...*



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# Thinking outside the bank

## *Alternative sources of business financing*

Maybe your business has had a relatively successful track record, but it's time to fund an aggressive expansion to stay ahead of the competition. Or perhaps you've hit a rough patch after years of strong performance and could use some extra working capital. Whatever the reason, you need a cash infusion — now.

A bank may appear the most direct route to success in your quest for financing. But commercial lenders are a selective bunch. The stars seemingly have to be aligned just right to receive a traditional bank loan, and businesses in certain volatile industries need not apply.

Fortunately, when banks can't or won't give you the funds you need, there are some alternatives you can explore.

### **Overlooked personal wealth**

Yes, there may be gold in your pockets. Chances are you've bankrolled your business in the past, maybe to provide startup funds. You may still have additional, unconsidered resources you could tap.

One perennially popular source is home equity. Many entrepreneurs and consumers have already drawn from this well during the recent refinancing boom.



Home equity loans are almost always a good source of funds because you can borrow at a reasonable rate and the interest is generally tax deductible.

Another attractive way to self-fund your business is to borrow against, or withdraw funds from, a permanent life insurance policy. Loan rates tend to be reasonable, and the interest is generally a deductible business expense. Moreover, depending on your policy, you may have the option of not repaying the loan at all. Some insurers will simply deduct any shortfall from the death benefit.

Yet another asset you may be able to tap is your 401(k) account. Just bear in mind that this approach isn't tax deductible and you'll be hit with a 10% penalty and taxes if you fail to repay the loan.

In each of these self-funding situations, you are your own lender. Therefore, you may find the terms and strings attached more palatable than going to an outside party.

### **Venture capital**

This financing source is certainly not for everyone. In fact, even though the venture capital market is slowly regaining momentum, only about 450 venture funds invested in 2,715 enterprises during 2003, according to the National Venture Capital Association. That's down from more than 8,000 deals in 2000, the height of the technology boom, says the same organization.

Venture capitalists favor young, innovative businesses with strong growth potential, usually those in industries such as biotechnology, software and communications. The amount invested can range from \$1 million to \$10 million per company. In exchange for their

largess, venture capitalists usually require a significant ownership stake and may want considerable control over a business.

## Angel investors

This term refers to informal networks of investors who invest in companies for their own interests, often to promote economic development in a region. Angels are generally more accessible funding sources than venture capitalists, funding 42,000 ventures in 2003, according to the Center for Venture Research at the University of New Hampshire. The typical investment varies considerably but is usually in the \$300,000 to \$5 million range.

Angels may offer loans at low interest rates but, more commonly, they want an equity interest in the business and an advisory role. They are good sources for startup capital, as well as later rounds of financing.

You can identify potential angels through networking, trade associations and professional advisors such as bankers, CPAs and business lawyers. Increasingly, angel investors are forming regional networks or clubs, many of which you can locate via the Internet.

## Commercial finance companies

For businesses that may not look attractive to banks or outside investors, a commercial finance company can be a knight in shining armor. These companies are willing to lend to businesses that are highly leveraged, undercapitalized or rapidly expanding. Fixed assets, inventory and accounts receivable usually secure the loans. Hence, many use the term “asset-based financing” to refer to these arrangements.

Loans from commercial finance companies are fairly easy to get, and large loans are preferred — typically \$500,000 and up, though you may find loans for as little as \$100,000. Interest and fees tend to be higher with smaller loans, though — anywhere from 12% to 28%. But the ease and availability of asset-based

financing may offset the negatives. A good way to learn more about this option is through the Commercial Finance Association ([www.cfa.com](http://www.cfa.com)).

## SBA loans

The federal government’s Small Business Administration (SBA) offers a variety of financial support. SBA 504 loans extend for 10 or 20 years and offer amounts up to \$1.3 million. Funding comes from “Certified Development Companies,” which are local, regional and statewide economic development organizations certified by the SBA.

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If you need a smaller amount of capital, you may be able to obtain up to \$35,000 through a “microloan,” a short-term arrangement with a maximum six-year term. These arrangements are also administered through SBA-approved nonprofit groups, such as local economic development organizations or state finance authorities.

## A personal choice

Ultimately, your specific business situation will dictate your financing options. Why you need the capital, how much you need and your company’s operating position all play into identifying possible funding sources.

Once you determine your needs — and the terms or circumstances you’re willing to accept — you should be able to zero in on the most likely and appropriate financing source. □



# Have more to lose? Leave less to chance

## *Estate planning options for business owners*

Estate planning is no cakewalk for anyone. But, as a business owner, you have even more complex issues to contend with. Because your personal assets are likely tied into your business, you must decide how to eventually dispose of your company as part of your estate.

You may be thinking, “What’s the hurry?” Perhaps you’re just hitting your stride (or are in a nice groove) as a business owner and don’t anticipate exiting any time soon. You might even think that making plans for your company’s future could send the wrong message to employees and others.

But because the ability to continue running your business isn’t among life’s few guarantees, you need to be prepared for anything.

### **Prevent a forced sale**

One of the most compelling reasons to create an estate plan is to minimize taxes. The inability to pay estate taxes is a major reason why many companies fail to



survive beyond the original owner. Without an estate plan, your heirs may have to sell the business — and often at a fire-sale price — to pay the tax burden.

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Of course, how much your heirs might owe depends on when you die and the value of your assets at death. This year, the estate tax exemption is \$1.5 million. It will gradually increase until it reaches \$3.5 million in 2009 and disappears in 2010, when the tax is repealed for one year.

If the current tax law is not amended, the exemption returns to \$1 million in 2011. Also, before being eliminated in 2010, the maximum estate tax rate will gradually decrease from 47% this year to 45% by 2007. And, depending on where you live, state or inheritance taxes may also figure in.

Fortunately, business owners seeking to reduce estate taxes, transfer as much wealth as possible and prevent forced sales of their companies have many options.

### **Pick a good policy**

Life insurance is often used to pay estate taxes, helping to keep closely held businesses intact after an owner’s death.

## Keeping the peace: More considerations for family businesses

Like other entrepreneurs, family business owners need to minimize estate taxes, divide their wealth and ensure the continuation of their companies. But they must do so while preserving family harmony. Not surprisingly, this can be difficult. Here are some tips for keeping the peace:

**Communicate with your heirs.** Don't assume family members want what you want for the business — ask them. You can then reconcile their vision with yours, providing a solid foundation for informed estate planning.

**Focus on the company's best interests.** Most family businesses represent a substantial piece of the family's wealth. Therefore, protecting the company's value and its ability to continue should be your primary consideration.

**Link management and control.** Control of the business should rest with those who operate it. Don't undermine the ability of active participants to effectively manage the company by giving nonactive family members too much power.

**Aim for fair asset distribution, not necessarily equal ownership.** Being fair doesn't always mean doling out business interests in equal portions. Rather than creating two ownership factions — those who work in the business and those who don't — consider giving nonactive family members other assets equal in value to any shares distributed to active members.



If proceeds from a life insurance policy would push your estate's value over the limit that can be passed to heirs tax free, you may want to consider an irrevocable life insurance trust (ILIT). It takes over ownership of your policy, pays the premiums, receives the death benefits and distributes the money according to the trust terms.

Life insurance owned by your business partners that names them as beneficiaries can also supply funds to allow partners to buy one another's shares at death, providing the decedent's family members with an easy way to sell the business interests. If you want to sell your shares at death, or in the event you're unable to continue the business, you should also execute a buy-sell, or shareholder, agreement. It outlines procedures for transferring your business interests, including how the shares' value will be determined.

One caveat: If you plan to use life insurance to pay estate taxes or provide liquidity to buy out business

interests, you need to conduct a business valuation to ensure you have a realistic estimate of your company's value. Many business owners fail to adjust their estate plans to keep pace with the growth of their companies. As a result, their heirs are often surprised by a higher-than-anticipated tax bill and may lack the funds to cover the tab.

### Give it away

The annual gift tax exclusion is another popular strategy for shifting income or other assets to family members, thereby reducing the size of your taxable estate. You can avoid the gift tax by limiting gifts to \$11,000 per person (\$22,000 if you and your spouse give jointly). Because your business may be your most valuable asset — and particularly if it's likely to grow in value — you may want to consider gifting shares.

Family business owners often use family limited partnerships (FLPs) or family limited liability companies (FLLCs) to transfer business interests to children.

Because the transferred shares represent minority interests that lack marketability, you'll retain control of the company and the shares will be discounted for gifting purposes — sometimes by 30% to 40% or more. This allows you to make larger tax-exempt gifts than if you simply give cash.

## Succeed on both levels

Business owners should strive for an estate plan that works on both a personal and a business level. You need to consider the pros and cons of the strategies we've just addressed as well as others before taking action. Only by planning in the here and now can you ensure the security of your family — and your business — in the future. □



## Moneylines: News briefs for businesses and individuals

**Nest eggs grew in 2003.** Thanks in part to a rebounding stock market, 401(k) plan account balances increased in 2003, according to a 2004 study by the Employee Benefit Research Institute (EBRI). For those holding accounts between 1999 and year end 2003, the average balance rose by 29% across all age groups. There's no magic formula to ensure great 401(k) returns. But the EBRI study showed a typical asset-allocation mix of equity funds (45%), company stock (16%), guaranteed investment contracts or other stable value funds (13%), bond funds (10%), balanced funds (9%), money funds (5%) and other investments (2%).

**IDITs become more powerful.** Intentionally defective irrevocable trusts (IDITs) have long aided those who want to reduce their estates, retain control over their assets and provide a benefit to a family member — and who are comfortable shifting income to do so. Now a new IRS ruling (2004-64) makes IDITs even more useful, because income taxes paid on trust assets don't count toward the \$11,000 annual gift tax exclusion.

**IRS gets “personal” with tax-rate enforcement.** Personal service corporations, such as lawyers' and doctors' offices, accounting firms, and consultancies, are subject to a flat 35% tax rate instead of the graduated rates available to most corporations. The IRS recently announced stricter enforcement of the flat rate for corporations that used a lower tax rate to calculate their 2002 and 2003 tax liability. If your organization receives an IRS enforcement letter, you may appeal in writing by stating that you disagree, explaining your reasoning, and citing the law or other authority supporting your position.

**Health costs rising more slowly than expected.** Are your employees worried about escalating health care premiums? If so, you may want to inform them that, on average, the increases will be smaller in 2005 than in 2004, according to a 2004 study by benefit consultants Hewitt Associates. Insurers initially proposed increases averaging 13.7% for 2005, but employers lowered that amount through negotiations, coverage reductions and other plan changes.



# It's never too late to learn more about college funding

Soon after their twins, Laura and Amy, were born, Edison and Toni started researching college funding strategies. They found lots of positive information about 529 plans, so they opened up a couple. But a little while later, Edison began to suspect they were overlooking other ways to save. Wisely, they turned to their financial advisor for help.

The advisor reminded Edison and Toni of the many breaks Uncle Sam offers. For instance, in 2005, you can deduct up to \$4,000 of college tuition and fees paid for you, your spouse or any other person you claimed as a dependent. But \$4,000 is the annual maximum, regardless of how many students you're supporting.



Alas, you won't qualify for the full deduction if you're a joint filer with a modified adjusted gross income (AGI) above \$130,000 or unmarried with a modified AGI above \$65,000. But if you're a joint filer with a modified AGI between \$130,001 and \$160,000, or single with a modified AGI between \$65,001 and \$80,000, you can still deduct up to \$2,000. Other rules apply that may void the tax break, so don't assume you'll automatically qualify. This deduction benefit is set to expire at the end of 2005.

## Take some credit

The Lifetime Learning credit may also boost college savings. If you pay \$5,000 in tuition for your child, you'll reap a 20% credit, or \$1,000. And if you pay \$8,000, your 20% credit becomes \$1,600. This credit tops out at \$2,000 per year (20% of \$10,000) per student, and it does not apply to expenses for books or room and board.

In addition, the Hope Scholarship credit provides a discount of up to \$1,500 per student annually. It covers 100% of tuition for the first \$1,000 and half of the next \$1,000. But eligibility is stricter compared with the Lifetime Learning credit. You may claim the Hope credit for

only the first two years of college, and the student must be enrolled at least half-time in an eligible degree program.

Thus, Edison and Toni couldn't claim both credits for the same student. But they could apply, say, the Hope credit to Amy and the Lifetime Learning credit to Laura.

For joint filers, eligibility for both the Hope and Lifetime credits starts to phase out when their modified AGIs exceed \$85,000. For everyone else, the phaseout starts at \$52,000.


## Consider a Coverdell ESA

Taxes aside, there are also other funding arrangements besides 529 plans. For example, you can contribute up to \$2,000 to a Coverdell Education Savings Account (ESA) this year. And that goes double for couples with two kids in college. Here Edison and Toni could sock away \$2,000 annually to separate ESAs for each student. Annual contributions are allowed up until the account beneficiary (the student) turns 18, or later for a special needs student.

If you're unmarried, income phaseouts apply to modified AGIs between \$95,000 and \$110,000. For joint filers, the phaseout range is between \$190,000 and \$220,000. ESA earnings build up tax free; then the money can be withdrawn (also tax free) to pay the student's college expenses.

Contributions are nondeductible, but the tax-free withdrawal feature compensates for that. If the beneficiary doesn't attend college or doesn't incur enough expenses to exhaust his or her account, the balance can be rolled over tax free into another family member's ESA.

## Start studying now

Edison and Toni leave their advisor's office relieved. They know there are plenty of ways besides a 529 plan to build their daughters' college savings. If you're concerned about funding an education, start studying now. 



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