

## **The Family Plan**

**The banks say no. Venture capitalists say no. It's time to turn to the ones who love you.**

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When Kenneth Wisnefski needed a cash infusion to expand his two-year-old online vendor site back in 2005, he didn't have many sources left to tap.

The Mount Laurel, N.J., entrepreneur had already dug into home equity, and he had exhausted his credit cards. Without an established track record, he couldn't get a traditional bank loan. Venture capitalists wanted to see more revenue, and angel investors demanded too much control.

So Mr. Wisnefski turned to a lender who would overlook his weak points, give him flexible terms and offer a dream-come-true interest rate: his dad.

Over a handshake, he secured \$100,000 in financing at 0% interest to push his business, VendorSeek.com, to the next level. "The terms of the agreement were: It was payable when I could pay it back to him," Mr. Wisnefski says.

Such funding often is the only choice for many small-business owners who have used up all other options. A study on entrepreneurship conducted last year by Babson College in Wellesley, Mass., found that the average amount needed to start a business was \$65,000. Two-thirds of that came from the entrepreneur's savings, while the balance came from "informal investors" -- most typically family members and friends.

### **No Expectations**

Informal arrangements like Mr. Wisnefski's often are handled with little more than a slap on the back for good luck and no expectations that the money will be repaid quickly, if at all.

And some small-business experts say that's the most realistic approach to take. "You should make sure the person who is putting up the money is fully aware they might lose it all," says William Bygrave, a professor of entrepreneurship at Babson and a co-author of the entrepreneurship study, along with professors at the London Business School.

Mr. Bygrave's research found that most informal investors appeared willing to shell out the cash out of "altruism," and the majority didn't expect a return, or even repayment of the principal. "It's more like a kind of loan that people think *might* get repaid," he says.

Mr. Bygrave says he generally doesn't advise that start-up business owners formalize the terms of the loans, at least at first, because doing so indicates to the family member or friend that the money will soon be repaid. Instead, the deal should stay loosely structured until the company has reasonable cash flow and can afford regular payments -- a position many businesses don't reach until three to five years down the road, if at all, he says.

But others say an agreement that is too vague and undocumented could lead to problems later on. Mark Luscombe, a principal tax analyst for CCH, a Riverwoods, Ill., unit of Dutch publisher Wolters Kluwer, says it's a good idea to put an arrangement in writing, whether the money is a loan, a gift or a contribution of capital to the business. "It helps ease confusion," he says.

Documentation comes in handy if, say, the Internal Revenue Service or even a jealous sibling raises questions about whether the money is a loan, a gift or an investment. Mr. Luscombe suggests drawing up a promissory note and consulting a lawyer for advice, particularly if repayment terms are loose or unusual.

The one potential drawback of documentation, he says, is "failing to follow the terms." For instance, some friends or family members might document that the money they've given is a loan, but neglect to collect interest or any type of repayment, he says. The IRS might ultimately decide that the loan was actually a gift -- and that the lender owes gift tax, plus interest or penalties.

Virgin Money, a unit of Virgin Group PLC, helps structure arrangements between business owners and relatives or friends. The company, based in Waltham, Mass., offers two plans.

The Handshake Basic is generally for loans of less than \$10,000. It provides the parties with documents, such as a promissory note and payment schedule. A more formal plan, the Business Builder, is typically for loans between \$25,000 and \$100,000. It has the same features as the Handshake Basic but also services the loan -- including setting up electronic fund transfers, sending email reminders and providing online account access. It also sends out year-end reports to the borrower and lender. The loans are flexible, usually offering lengthy grace periods and interest rates and payment schedules favorable to the business owner.

Virgin Money charges an upfront fee (\$99 for the Handshake Basic and \$199 for the standard Business Builder plan). And with the Business Builder plan, it collects \$9 per payment regardless of the loan size or frequency of payment.

"The advantage of paperwork is that it forces a conversation about what people's expectations are," says Asheesh Advani, Virgin Money's president and chief executive.

He recommends that business owners structure money from friends or family as a loan, rather than equity, "unless they are convinced that the company is a high-growth company that actually will be bought by somebody someday." Mr. Advani says the benefit of a structured loan -- and having a third party properly document and manage it -- is that the lender can claim a capital loss if the business goes belly-up, and the borrower can deduct interest payments, just like a regular loan.

In the event a company doesn't succeed, he adds, it's better for the friend or family member to be a creditor, as they have a better chance of recouping the loan in bankruptcy proceedings.

There are some other considerations for both business owners and their friendly lenders to keep in mind.

From an estate-planning perspective, it's generally best to give the money as part of the annual gift amount of \$12,000 (a couple could give \$24,000) that doesn't trigger the gift tax, says Joseph Kluemper, a senior tax manager in the family wealth planning group at accounting firm BDO Seidman in New York.

People who have exhausted their lifetime exclusion of \$1 million for gifts should structure the money as a loan -- and consult with an accountant or an estate planner about charging the market interest rate (called the applicable federal rate) and setting a payback schedule.

"With any transactions between family members, the IRS has a heightened degree of scrutiny," Mr. Kluemper says, especially if it looks like the family is trying to avoid paying gift taxes, which have a rate of up to 45%.

But if you're likely to seek loans from conventional lenders later on, it's better to treat your family infusion as a gift. Lenders may question any lump of cash that shows up on a balance sheet -- and whether that money was a gift or a loan. The most pressing question would be, "Is there truly an expectation of repayment?" says Mark Hogan, president of small-business banking at Bank of America Corp. in Charlotte, N.C. In the eyes of the bank, he says, it's more favorable for the money to be a gift rather than "just another loan on top of the loan they're looking for from the bank."

### **Taking on a Role**

For VendorSeek's Mr. Wisniewski, the \$100,000 loan from his father -- which was used to boost advertising, hire staff and make capital improvements -- has helped the business grow significantly. Revenue last year topped \$1 million and is expected to exceed \$4 million this year, he says. Profits are being reinvested in the business -- and he has paid back about \$25,000 to his father so far, making payments whenever he can.

Kenneth Wisniewski Sr. says he lent the money to his son because "I'm just like any father anywhere in the U.S.... [We] obviously trust our sons and want them to do well."

But his loan did come with an unusual twist: While the elder Mr. Wisniewski, 64, didn't expect repayment, he did request to become a senior account manager at VendorSeek. He says he wasn't prepared, financially or otherwise, for retirement, and thought his years of sales experience at his own auto-parts distributorship could help his son. So the position was created for him, and he receives a salary and benefits.

While the two men sometimes butt heads, the arrangement has worked out well. "It's turned out to be a great benefit," the younger Mr. Wisniewski says. "We've got a lot of dedicated people, but he's the person who's still working at 9 p.m. on Friday nights."