The Law Office of
LYNNETTE ARIATHURAI
a Professional Corporation

REPORT FROM COUNSEL

FALL 2011 ISSUE

SBA LOANS CAN HELP TO FINANCE SMALL BUSINESSES

It is no secret that businesses generally, and small businesses in particular, have been through rough times, and those are not over yet. Still, there is some assistance to be had as a small business owner if you know where to look. One prominent example is the Small Business Administration (SBA) and its Guaranteed Loan Programs.

Contrary to a common misconception, the SBA does not make direct loans to small businesses. Instead, the SBA establishes the guidelines for loans, which are then made by its "partners," meaning lenders, community development organizations, and microlending institutions. To eliminate some of the risk to the lending partners, the SBA guarantees that these loans will be repaid. In short, a business applicant is actually applying for a commercial loan, structured according to SBA requirements, with an SBA guaranty.

SBA-guaranteed loans may not be made to a small business if the borrower has access to other financing on reasonable terms. Because SBA loan guaranty requirements and practices can be changed by the government, it is important for potential applicants to obtain current and accurate information.

7(a) Loan Program

This program, the most basic and most used of the SBA loan programs, is for eligible borrowers who want to start, acquire, or expand a small business. The loan is obtained from a

participating lender institution, and it provides long-term, fixed-rate financing for major fixed assets, e.g., land and buildings. The loan proceeds can also be used to acquire equipment, supplies, and materials, or for long- or short-term capital needs. Loan terms range from up to 10 years for working capital to up to 25 years for fixed assets. There are a few prohibited purposes for which a 7(a) loan cannot be used, such as for the financing of nonprofits, real estate investments, and monopolies.

CDC/504 Loan Program

The CDC/504 Loan Program is a long-term financing tool designed to encourage economic development within a community. It accomplishes this goal by providing small businesses with long-term, fixed-rate financing to acquire major fixed assets for expansion or modernization.

A Certified Development Company (CDC) is a private, nonprofit corporation that is created to contribute to economic development within its community. CDCs work with the SBA and private sector lenders to provide the financing to small businesses.

Typically, a project of this kind includes (1) a loan secured from a private sector lender, with a senior lien covering up to 50% of the project cost; (2) a loan secured from a CDC (backed by a 100% SBA-guaranteed debenture), with a junior lien covering up to 40% of the project cost; and (3) a contribution from the borrower of at least 10% of the project cost (equity). This arrangement means that 100% of the project cost is covered either by the contribution of equity from the borrower or from the senior or junior lien.

Proceeds from 504 loans must be used for fixed-asset projects, such as the purchase of land, including existing buildings; the purchase of improvements, including grading, street improvements, utilities, parking lots, and landscaping; the construction of new facilities or the modernizing, renovating, or converting of existing facilities; and the purchase of long-term

machinery and equipment. The CDC/504 Loan Program cannot be used for working capital or inventory, consolidating or repaying debt, or refinancing.

Microloan Program

The Microloan Program gives small, short-term loans to small business concerns and certain types of not-for-profit child-care centers. The SBA makes funds available to specially designated intermediary lenders. These are nonprofit community-based organizations with experience in lending as well as in management and technical assistance. These intermediaries make the loans to eligible borrowers. The maximum loan amount is $50,000, but the average microloan is about $13,000.

Microloans may be used for working capital, the purchase of inventory or supplies, the purchase of furniture or fixtures, or the purchase of machinery or equipment. Microloan proceeds cannot be used to pay existing debts or to purchase real estate.

If you are a potential borrower, the SBA recommends four steps to take to get the ball rolling in its loan programs. First, estimate your business startup costs or the funds that you need to grow the business. Second, contact a local bank or lender to review the available loan programs for small businesses. Third, prepare a draft loan proposal. Finally, discuss all of the above with someone having solid knowledge of SBA loans, such as a representative of the SBA itself.

CHALK ONE UP FOR THE LITTLE GUY

Nate Thoma is not a lawyer, but he is a soft-spoken, yet confident, small investor in Washington Mutual, the big bank that was seized by the federal government in 2008 and ended up in bankruptcy. As for so many other investors, Nate's stake in the bank was wiped out. Nate became something of a folk hero during that tumultuous period when big banking institutions

were failing and the little people always seemed to get the short end of the stick as the messes were being cleaned up.

Nate's big moment came when, after he had spent untold hours analyzing the Washington Mutual case, the federal bankruptcy judge let him have his say—and at some length—in a hearing that culminated in an investigation of trading by some very large hedge funds and in the rejection of a bankruptcy plan for the bank.

The issues made for a real legal thicket, especially for a novice to sort out. Essentially, Nate's complaint, on behalf of the many small investors in the bank, was that the hedge funds were buying up the bank's trust preferred securities that go to the front of the line for any money distributed from the bank's estate.

The hedge funds also owned the bank's bonds, so their dominant ownership of both classes of securities would help them control the course of the bankruptcy, to their benefit and to the corresponding detriment of the little guys. Nate's oral argument and his accompanying 33 pages of supporting documents no doubt played a role in an eventual favorable settlement between small investors like himself and the hedge funds, a settlement that may also have shown the way for the bank's exit from bankruptcy.

ESTATE PLANNING WITH ILITS

For some people, life insurance may not spring to mind immediately as an effective estate planning tool. A life insurance policy remaining in the estate of the insured is subject to federal estate taxes. However, when carefully crafted and put in place with the guidance of an appropriate professional, there is a way both to obtain the familiar benefits of a life insurance policy—providing a measure of financial security for the beneficiaries—and to remove the policy's proceeds from exposure to the estate tax. The vehicle is called an Irrevocable Life Insurance Trust (ILIT).

Here is how an ILIT works. At the core of the trust is the life insurance policy itself. The "grantor" of the trust makes annual gifts of sufficient money to pay the premiums on the policy and to cover administrative costs, unless the trust is funded by other assets.

The legal owner of the policy is the trust, not the grantor, which explains how the insurance policy is treated as being outside of the grantor's estate. The insured cannot personally benefit financially. Another plus arising from the fact that the trust owns the policy is that this protects the funds from possible claims by the beneficiary's creditors.

As with any trust, an ILIT must have a designated trustee to manage and administer it. Typically, the trustee is a bank or a trust company, but practically any person or entity other than the grantor can serve in that role. The trustee establishes a bank account into which the gifts will be deposited for use in paying the premiums. The trustee is also responsible for a variety of administrative duties, including giving notifications to the beneficiaries under the policy and filing the ILIT's tax return.

Upon the death of the grantor, it is also the trustee who oversees distribution of the policy's proceeds, in accordance with the grantor's wishes as expressed in the trust. This distribution can be all at once or spread out over time.

One of the appealing features of an ILIT is that it can be closely tailored to fit the wishes of the grantor regarding the conditions and circumstances for paying out the proceeds of the ILIT. There are almost as many possibilities as there are individual grantors. For example, if the grantor is in a second marriage, the ILIT proceeds might go to any children from the first marriage, with the rest of the estate going to the second spouse and the children from the second marriage. It is also possible for the grantor to specify and achieve very specific purposes for the ILIT proceeds, with strings attached if desired. Think carrots and sticks: A beneficiary might be in store for proceeds from the ILIT only if he or she satisfies certain conditions or meets certain

goals. On the more negative side, misconduct by a beneficiary could be used as an effective disqualification.

Bear in mind that an ILIT must comply with certain government rules and regulations if it is to achieve the desired results. Thus, aside from the potential complexities of the instrument itself, the assistance of a professional is a must in navigating the government's requirements for an effective ILIT.

DON'T LOSE YOUR CHARITABLE DEDUCTION

For you to claim a federal income tax deduction for a charitable donation valued at $250 or more, you must obtain from the recipient of the donation a "contemporaneous written acknowledgment" letter. Failure to obtain such a letter can result in a disallowance of the deduction by the IRS.

The acknowledgment letter, which may be in the form of a thank you letter to you as the donor, should include the following information:

- the name and address of the recipient of the donation;
- the amount of a cash gift or, if not in cash, a description of the donation sufficient to identify the nature of the gift; and, if applicable,
- a statement that no goods or services were provided by the recipient in return for the donation, or a description and good-faith estimate of the value of any goods and services that were provided by the recipient in return for the donation.

As some donor taxpayers have discovered to their consternation, including some who have made very large donations, the timing of the receipt of the letter can be as important as its contents. The rule to bear in mind is that you must obtain the acknowledgment letter by the date of the filing of the tax return for the year in which the charitable contribution was made. You run the risk of being denied the deduction in assuming that it will suffice if the letter has been

promised or will be received after the return has been filed but before you would ever hear from the IRS.

Recently, the Chief Counsel for the IRS underscored the need for having the donation acknowledgment letter in hand (or in your e-mail inbox) when you file your return in order to qualify for the deduction. The federal Tax Code actually has a provision that states that the donor is not required to obtain an acknowledgment letter if the recipient organization itself files a return that meets applicable requirements and includes the required information about the gift. Nonetheless, because no implementing regulations on this law have yet been issued, the Chief Counsel determined in a memorandum that a donor cannot take this route to claim the deduction.

The takeaway lesson for donor taxpayers is to be sure that you receive your acknowledgment letters before you file, and don't make the mistake of assuming that the IRS will cut you some slack if, for whatever reason, that deadline is missed.

FINANCIALLY SPEAKING, KEEP IT SIMPLE

In theory, we are all in favor of saving time, labor, and space, not to mention avoiding the stress and anxiety that can come from leading complicated and disorganized lives. In the realm of personal finance, these are all good reasons to resolve to become more simplified and organized, but saying and doing are two different things. It may help move the process along to break the job up into some very specific things that you can do in addition to making an overall change in attitude toward your finances. Minutes spent doing this ahead of time could save hours and many dollars later.

Direct Deposit

Who knows, you may be one of those people who like to have the check in their hands for their pay, pension, or Social Security benefits so that they can personally take it to that bank

teller they have known and trusted for years. Still, arranging for a direct deposit into a bank account is safer, easier, and more convenient, and, at least by a small margin of time, it allows you to get access to your money more quickly.

Recurring Bills

If the merchant, such as a utility or insurance company, allows the practice, you can pay recurring bills with an automatic withdrawal from your checking account or with a charge to a credit card. In the case of the former, don't forget to record the transactions in your check register. In the same vein are online banking services that allow you to pay bills online instead of by snail mail.

Online Banking

Aside from bill paying, consider doing virtually all of your banking online, making it effectively paperless. You can go online to handle such tasks as reviewing deposits and withdrawals, tracking balances in your accounts, transferring funds between accounts, and receiving statements.

Automatic Savings

It is simply common sense that if you set up a system in which something happens automatically rather than only when you think about it and take action, the "something" is going to occur with greater consistency. So it is with saving for the future. Arrange with your employer or bank to put a predetermined amount of money into an account or an investment vehicle on a regular schedule. Another bonus for this approach as an investment strategy is that over the long run, it might provide a better return than jumping in and out of the markets.

Consolidation

You might want to streamline your finances by consolidating what could be an unwieldy number of accounts and credit cards. By doing so, you can better monitor everything, lighten the

load of paperwork you receive, avoid some fees, and perhaps even obtain better deals. If you are combining deposits at one banking institution, though, be careful not to exceed FDIC deposit insurance limits ($250,000 for each ownership category in a single institution).

Up-to-Date and Available

Even if you have been diligent about making a will, review it periodically to make sure it still conforms to your wishes, especially if there have been any intervening major events that might prompt a change. The same goes for any number of important financial documents, such as life insurance policies and retirement accounts identifying beneficiaries and providing directives about what happens to bank accounts and other assets if you become incapacitated.

All of the above may not matter much if nobody can find the documents, so keep them in a secure place, ideally in a central filing system. Make sure to let your family members know where they can find your important documents.

If a Disaster Strikes

It is not a pleasant scenario to contemplate, but what if in an emergency you had to evacuate your home in moments and all of your carefully gathered and organized financial material were left behind? One way to prepare for this possibility is to keep copies of the important documents, or at least lists of account numbers and similar identifying information, on a secure website that you could access from any location.

EMPLOYEES WIN BENEFIT PROTECTIONS

A major health services company with thousands of employees overhauled its pension plan some years ago. As it explained to the employees at the time, their then-existing benefits would all be converted into a hypothetical lump sum, which would constitute the opening account balance for the new plan. That amount would then grow by a percentage of the

employee's pay each year. It all sounded as though there was nothing to which the employees could object.

But what was not explained to the employees, and what eventually led a class of employees to sue under the federal Employee Retirement Income Security Act (ERISA), was that the beginning balance for many employees with long tenures at the company would be as little as 50% to 70% of the amounts built up under the old pension plan. Calculated in such a manner, the pension balances for such employees could take years just to get back to the levels of the old plan.

The now illegal practice that led to the litigation has happened often enough that it has a name: "wear-away." The employer's creation of "underwater" beginning balances effectively tells employees that prior pensions were overpaid and that before they can receive compensation under a new pension plan, they effectively must work off a debt, or "wear it away."

When the case ultimately reached the U.S. Supreme Court, a majority of the Justices agreed with the plaintiffs that if the company had deliberately provided misleading and incomplete information to its employees, in violation of ERISA, a monetary remedy was appropriate. This was a resounding win for the employees, given some earlier case precedents making it difficult to recover monetary awards for employment benefits lost due to employer violations of their duties.