

Using Private Funding to Raise Capital for Your Business

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What is private funding?

Private funding is capital for your business that comes from individuals rather than from institutions like banks and venture capital firms. These individuals may be friends, relatives, business associates, or wealthy individuals with an interest in small businesses. You might even invest in (or lend to) your own business. Private funding may be in the form of either debt or equity and is often much less formal than institutional funding such as bank loans and venture capital investments. However, you should follow certain guidelines to avoid unnecessary complications, especially if the funding comes in the form of a loan.

Private placement: equity funding from private sources

Believe in angels

Private placement funds often come from friends, family members, and business associates, but you might get lucky and find yourself an angel. Angels are wealthy individuals who are always on the lookout for a product, service, company, or entrepreneur with whom they can identify. Many of these individuals genuinely want to be helpful by providing money and experience to aid promising new businesses.

Know how to deal with private investors

- Your investors own a part of your business, so make sure you share a common vision.
- You are giving investors an opportunity to make money, but they are also taking a risk on you. Treat them appropriately.
- Allow room for additional investment in the future.
- Don't attempt to raise capital when you're desperate.
- Be flexible with your investment proposals.

Be aware of securities regulations

Most private placement transactions are exempt from federal securities regulations, due to the relatively small dollar amounts. However, you may need the help of an attorney to make sure you qualify for the exemptions. Although you may not be required to comply, you should probably pay attention to the disclosure and antifraud provisions of the federal security regulations if you want to avoid a lawsuit. You may also need to comply with state securities regulations.

Private loans: debt funding from private sources

As mentioned, private funding may be in the form of a loan from a friend, a family member, or a business associate. Although these loans can be extremely flexible, and although you may be able to negotiate better terms than you would obtain through a traditional lender, they can put a whole new spin on an existing relationship. The following are some points to consider before taking a loan from a friend or family member to finance your business endeavor.

A loan that is not properly documented may be considered a gift by the IRS

If you don't document the terms of the loan (including principal amount, interest rate, repayment schedule, and collateral, if applicable), the IRS may view this transaction as a gift. Gifts that exceed the annual gift tax exclusion are generally taxable, though any tax due may be offset by your applicable exclusion amount to the extent it is available.

Low-interest loans without a payable-on-demand feature may be subject to gift tax

It may seem harsh to structure a loan between friends or family members as a demand loan (meaning the lender can demand full repayment at any time), but potential gift tax liability can be avoided this way. If it is not a payable-on-demand loan, all imputed interest over the life of the loan

is considered a gift in the year the loan is made. Although gifts in the amount of the annual gift tax exclusion or less per year can be given tax free, the total imputed interest will likely exceed this annual limit. On a demand loan, the imputed interest is calculated on a yearly basis. This annual amount will likely be less than the tax-free limit. Imputed interest and gift tax liability can both be avoided if the loan carries an interest rate that is at least equivalent to the applicable federal rate.

Consider emotional consequences

Financial transactions between friends or relatives can be stressful for those involved. Emotional and financial consequences should be considered carefully before entering into such a transaction. Can your mother really afford to take a second mortgage on her house so she can make a loan to your business? What will happen to your relationship if the loan isn't repaid?

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