

## Behind the Counter

### External Sources of Financing for your business

When people think about financing, they usually think about getting a bank loan, but there are several sources other than a bank loan for financing.

For small business start ups we will consider personal sources of financing. If you have savings, stocks and bonds, you can use these to finance your business. You can also open a personal line of credit or take a second mortgage out on your home to finance your business. Banks will usually not loan money out to start a new business as the business has no history, instead they will loan the money to the owner personally based on credit worthiness of the owner and the collateral available to them. Normally the initial loan will be for a period of one year at which time the business situation will be reassessed. Credit card advances may be available to you, or you might be able to borrow against the cash value of your life insurance policy. If you have investments, you can structure your investments to provide a monthly income to you without spending the principal amount. You would need to contact an investment advisor or broker to set this up for you.

A word of caution is that you do not want to use all your resources to finance your business. You want to be able to have a reserve in case your business has a down period in the future. Also, if you cash in any of your investments, you may be subject to personal capital gains on the disposition, taxable at 50% on your personal return if you have used up your capital gains exemption.

From an accounting perspective, if you take out a loan personally for your business, you can record it as a proprietor's investment in the business and as funds become available, you will be able to repay yourself out of the business profits.

From a tax perspective, any interest that you incur as a result of financing your business can be deducted as a business expense. If your company is incorporated you can charge your business interest on the funds it has borrowed from you which will help you to recover your interest expense, however, you are required to record this interest on your personal tax return as interest income. Therefore, for incorporated businesses, it makes more sense to finance externally rather than personally.

If you have partners or if there are other shareholders, they may be interested in loaning the business money in exchange for a share of the profits. Employees may also wish to purchase a share of the business.

Family members could be approached for a loan. Any loans from family members require a promissory note drawn up between you and the family member. This promissory note should state the amount of the loan and the terms of repayment. This simple document will avoid any future misunderstandings between you and the family member and also be proof for the Canada Revenue Service in the case of an audit.

If you have purchased an existing business, perhaps the previous owner is willing to finance your purchase at a reduced rate. Perhaps a previous employee has received a sizeable severance package and is looking for a place to invest. The ideal situation would be a retired employee that is willing to invest in the business and makes his/her expertise available to the business creating a much stronger and improved company.

In some cases vendors are willing to loan business money as in the case of a distributorship where a vendor will loan money to a person in a particular area to set up business to distribute their product or service.

Customers can also be a source of financing by providing cash advances on their orders or partnering with a company in the development of a new product or service.

If you rent office space and there is an extra room that you are not using, or only using for storage, perhaps you can rent this space out to another entrepreneur and split the office costs.

In all cases, the terms of the loan need to be documented in some fashion either by way of a promissory note or some sort of contract with a vendor or a customer. This documentation will avoid many problems in the future.

These are not the only sources of financing, the discussion will continue in the next issue.

**HOT TAX TIP:** The Government of Canada proposes to reduce the GST rate from 6% to 5% effective January 1, 2008. For more detailed information go to <http://www.cra-arc.gc.ca/E/pub/gi/notice226/notice226-e.pdf>

Seasons Greetings to all and a Happy New Year.

Gabriele Banka is a Certified General Accountant and the owner of Banka & Company Inc. She can be reached at 763-4528 or [info@bankaco.com](mailto:info@bankaco.com).