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# Business Quarterly

## Borrowing Responsibly and Managing Debt

All business owners prefer to operate in the black. But, taking on debt is sometimes necessary as a company expands or when business slows due to economic volatility. Managing your debt carefully can minimize the cost of carrying debt and make it easier to move back into the black when the market improves.

Before taking out a new loan, make a list of your company's assets that can serve as collateral, including real estate, buildings, and equipment. Then calculate how much financing your business needs, outlining precisely how you plan to spend the money. At the same time, review your current operations, looking for ways to cut unnecessary costs or increase revenues. You may, for example, be able to renegotiate payment plans with suppliers to allow more time to pay off the amounts owed. Similarly, if your company is planning to purchase equipment, consider whether leasing can reduce the amount you need to borrow. Review your invoicing procedures, ensuring that your system for collecting payments is effective.

After you have explored all options for increasing revenue and reducing expenditures, revise your business plan to reflect your current needs. Potential lenders often want to see evidence that your company is run efficiently and that market conditions justify additional outlays. Even if business is down due to the economy, you may, for example, be able to demonstrate that your company is outperforming competitors and is in a position to rebound quickly.

If you wish to borrow money, start by approaching your current bank. While an extension of a line of credit may be sufficient to meet the short-term need for additional cash flow, consider options for locking in a manageable interest rate for any long-term debt. If the amount of money your bank is prepared to lend your company is insufficient,

continued on page four

## In This Issue

# Behavioral Economics Can "Nudge" Workers toward Better Decisions

Employers should consider using behavioral economic principles when designing their benefit offerings to improve how their employees use their retirement and health plans, and provide better outcomes for participants and employers, a recent study by human resources solutions provider Sibson Consulting has advised.

The study, "Beyond Rational Thinking: Using Behavioral Economics to Improve Workforce Health and Behavioral Outcomes," was written by Sibson vice president Christopher Goldsmith. After observing that one-third of all workers have no savings earmarked for retirement, and that more than 50% have accumulated less than $25,000 in their retirement savings accounts, Goldsmith noted that the financial services industry has begun to deploy several behavioral economic techniques in 401(k) plans in an effort to reverse this situation, including automatic enrollment, automatic contribution escalation features, and target date funds as default options. "These techniques have significantly helped solve two behavior-based problems: under-saving and poor asset allocation," he said.

Goldsmith also pointed out that people frequently make irrational decisions regarding health benefits and health care. For example, he said, while most employees understand the value of preventive health care and like the fact that their health plans offer preventive care services without deductibles, co-payments, or co-insurance, many still fail to obtain free health screenings or physical exams. He also noted that few people access the substantial amount of data available about hospital costs and mortality, re-admission, and hospital-acquired infection rates when making decisions about hospitals and surgeons.

In each of these examples, Goldsmith argued, behavioral biases cloud rational judgment. "Understanding these tendencies can help organizations redesign how they configure and communicate their health benefit plans to 'nudge' people toward better decisions that produce better outcomes for participants and employers," he asserted.

According to the study, behavioral economics can prove useful in an employer's open enrollment process when the goal is to steer employees toward more cost-effective health plan options. For example, if an organization wants employees to migrate from an expensive preferred provider organization (PPO) to one of several lower-cost plans, it must confront three behavioral biases: the loss-aversion bias, in which people tend to overvalue the prospect of losing something of value and undervalue the prospect of gaining something of value; the value system bias, in which people have deeply rooted value systems and selective filters that work against change; and the status quo bias, or the tendency not to change, especially when choices are complex.

Due to these behavioral biases, Goldsmith said, when employees weigh their health plan choices, they tend to focus on the potential loss of their current doctor-patient relationship and undervalue the financial gains associated with the alternative plans. However, there are two behavioral biases that the organization can leverage in its open enrollment materials to achieve better results: the clue-seeking bias, in which people look for clues when faced with complex decisions; and the framing bias, in which the presentation of choices has a substantial influence on the decisions people make. The employer can encourage workers to select one of the lower-cost health plan options rather than the PPO though effective "choice architecture," in which the framing, ordering, and description of the various plans are adjusted to make certain options more attractive than others.

In another example, Goldsmith illustrated how behavioral economics and motivation theory can be used by employers to encourage employees to participate in the company's wellness programs. He cited research showing that, as the incentive value increases, so too does participation in an organization's health risk assessment activities. By contrast, poorly designed incentives that are too low, too high, too complex, or too distant will likely fail to achieve desired outcomes.

To start applying behavioral economics, Goldsmith recommended that organizations make an inventory of existing program designs and communications to assess current behavioral biases and consequences, clarify the desired shifts in behaviors and decisions to achieve improved outcomes, identify alternative configurations for program design and for reframing that will nudge participants toward better choices about benefits and personal health, estimate the costs of reframing, and develop an action plan for change.

"Those responsible for the design and communication of health benefit plans and healthy enterprise initiatives are de facto choice architects," Goldsmith concluded. "The ordering of options, highlighting of decision factors, naming of programs, structuring of incentives, and selection of defaults are decisions made by management. Current decisions have consequences in terms of workforce behavioral bias, choice making, and engagement."

# Your Business: Passing the Torch

Let's assume that you've decided to transfer your business to another family member. However, you are concerned about the tax consequences of relinquishing ownership, and how your future personal cash needs will be met. Consequently, you are a little unsure how best to proceed.

You could gift your entire interest in the business, but there are several reasons for *selling* at least *some* portion of the business to a family member(s) rather than making an outright gift:

- Gifting the entire entity could result in substantial gift taxes without providing you with any cash to help pay those taxes.
- You may need to get some cash out of the business for funding your retirement income needs.
- If some family members will not be involved in the business, you may also wish to obtain cash to provide equal treatment (i.e., compensation) to nonparticipating family members.
- You may want to use selling, rather than gifting, to help the acquiring family member(s) appreciate the value of ownership.

If structuring all (or some) of the transaction as a sale makes sense in your particular situation, there are tax-saving strategies that can benefit you and other family members.

## The Self-Canceling Installment Note (SCIN)

While a sale usually involves payments all at once upon the "closing," an installment sale is an arrangement that provides for payments in any year after the year of sale.

An installment sale can be very useful for spreading out both buyer payments and seller tax liability over a period of years. It also "freezes" the value of a company at the time an agreement is reached between buyer and seller. By freezing a company's value, any future appreciation of the company is kept out of the seller's estate.

However, one limitation of a conventional installment sale is that if the seller should die before the note is fully paid, the buyer would still be liable for paying the balance to the seller's estate, and the present value of the future payments would be included in the decedent's gross estate.

By adding a **self-canceling provision** to the installment sale agreement, no further payments need be made by the buyer if the seller fails to outlive the term of the installment note. The balance of the note would not be included in the seller's estate for estate tax purposes (avoiding potential estate taxes). However, in the seller's estate there would be "income with respect to a decedent" (IRD) upon the cancellation of the installment note.

## The SCIN vs. a Private Annuity

Another technique for making intrafamily transfers is a **private annuity**, whereby the buyer(s) provides periodic fixed payments to the seller for a fixed term of years or over the seller's lifetime in exchange for ownership. Here are some points you may want to consider:

- If the seller outlives his or her actuarially determined life expectancy, under a private annuity, the buyer must continue to make payments. With a SCIN, payments end upon the noteholder's death or the expiration of the note's term.
- With a private annuity, payments made during the seller's life expectancy are subject to capital gains taxes. However, if the seller outlives his or her life expectancy, all subsequent payments are taxed at potentially higher ordinary income tax rates.
- With a private annuity, any remaining unpaid portion at the death of the seller would not be included in the seller's estate. With a SCIN, there is the potential for "income with respect to a decedent."
- Property purchased with a SCIN receives a step-up in basis. However, there is no step-up in basis with a private annuity.

## Sale and Gift Combination

Wealth preservation can be accomplished by combining a sale with gifting that maximizes use of the annual $15,000 gift tax exclusion—and takes advantage of the $11.4 million applicable exclusion amount. The key is having a business valuation that will withstand Internal Revenue Service (IRS) scrutiny, since the IRS can negate what it considers a "bargain sale" between related parties. Regardless of which strategy is right for you, with *proper* planning, you can transfer business assets to a family member in a tax-efficient manner while providing for your future cash needs.

## Borrowing Responsibly and Managing Debt

continued from page one

investigate the alternatives. Because lending practices vary, consider applying for loans from a variety of banks, including large institutions, smaller community banks, and credit unions.

For smaller loans, consider approaching a nonprofit lender that provides micro-loans through a program of the Small Business Administration (SBA). These lenders typically extend lines of credit of up to $35,000 and may require applicants to provide evidence that they have been denied a bank loan. Online peer-to-peer lending may also provide a smaller loan. Individuals or businesses wishing to borrow funds on a peer-to-peer website post a listing for a loan, including information about the amount needed and the rate they believe they can afford. Potential lenders then bid to fund the loan, offering varying amounts and rates.

If you are unable to obtain financing through these channels, investigate other SBA loan programs. Distributed through commercial lenders, loans can be guaranteed by the SBA with favorable terms to qualified borrowers. The 7(a) program makes loans up to $2 million for a variety of purposes, including larger capital purchases or short-term working capital needs. While the loan itself is made by the bank, the SBA limits the interest rates and fees the lender can charge. All businesses that are considered for financing under SBA's 7(a) loan program must meet SBA size standards, be for-profit, be without the internal resources (business or personal) to provide the financing, and be able to demonstrate repayment. The maximum length of the loan is 25 years for real estate and seven years for working capital. Certain variations of SBA's 7(a) loan program may also require additional eligibility criteria.

The SBA's 504 loan program also provides growing businesses with long-term, fixed-rate loans for the purchase of major fixed assets, such as land and buildings. However, the SBA may require personal guarantees from borrowers owning a certain percentage of the business. Visit www.sba.gov for more information on the types of loans available and the eligibility criteria.

In a challenging economic climate, your company may be in a very different position than the last time you sought financing. If an analysis of your current situation reveals a high debt-to-equity ratio, taking out additional loans or credit could expose you to too much risk. To avoid becoming too leveraged, consider looking for new investors. Depending on your needs, your capital requirements may be met through small investments from friends, relatives, business associates, angel investors, or employees. These deals should always be governed by a legal contract defining the terms of the arrangement, including the return on investment for stakeholders and the extent to which investors will be involved in running the business.

Many businesses often require financing for short- and long-term needs. Borrowing responsibly and managing debt effectively can help your company minimize the cost of debt you need to take on.