GROWERTALKS

Features

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The Real Cost of Borrowing

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Small business lending has taken a significant blow over the past few years. Lower interest rates have translated into lenders and investors being more selective. Fortunately, small-business lending, at least according to several surveys, is now rising.

With many larger businesses reducing their borrowing after the initial impact of the Tax Cuts & Jobs Act (TCJA), the increased attention on small business lending should come as welcome news to every grower and retailer. It also raises the all-important question of what it will actually cost to fund the growing operation or its expansion.

The high cost of money

Often overlooked is the cost of money. However, two factors impact how much a business loan will cost: the interest rate charged and the fees required before, during and after the loan process. They combine to create the annual percentage rate (APR), which is the cost of the loan every year a balance remains.

The type of loan needed by your business directly impacts the interest rate charged since, all-too-often, the rate stated by lenders doesn't reflect the true cost of a loan. In fact, the loan agreement may require a borrower maintain compensating balances and pay a number of fees. Among the most common fees are:

• **Packaging fee:** When applying for a loan, the borrower must provide a lot of information about their business, its finances, etc., which generally needs to be backed by appropriate documentation. If assistance is received from a third-party or the lender in completing the loan application, a packaging fee may be charged by the third-party or the lender for assembling the required documentation.

• **Processing/application fee:** A credit check of both the owner and the business, as well as perhaps even a personal background check, is often required. All this information is gathered and processed by lenders in order to make sure that the application package has everything necessary to analyze the probability that the loan will be repaid in a timely manner. The processing fee compensates the lender for the time, work and expertise required to complete this stage.

• **Underwriting fees:** Once a loan application package is complete, it normally goes to the lender's underwriting department, where either a person or a committee studies it, verifies that all the information provided is true, assesses the risk the lender would be taking and approves or denies the application.

• **Closing costs:** Closing costs are usually associated with mortgage loans and can include—but aren't limited to—expenses such as attorney fees, title search, realtor fees, etc. If a loan includes a real estate transaction, the lender will certainly incur closing costs. Sometimes these are absorbed by the lender or the seller in order to encourage the sale.

• **Maintenance or servicing fees:** These are fees the lender may charge on an ongoing basis (monthly, quarterly) to service a loan, i.e., handling payments, sending out notices, responding to inquiries, etc.

And there's a fee unique to U.S. Small Business Administration programs:

• **SBA Guaranty Fee:** When an SBA loan is granted, the business/borrower usually reimburses the fee the lender is required to pay to the SBA. (Think of this fee as "points.") The fee is based on a percentage of the amount of the guaranty that SBA is providing. Fortunately, the fee can be financed, allowing the borrower to add it to the principal amount to be repaid, substantially reducing its impact.

The cost of borrowing

In addition to this wide range of potential fees, the loan agreement may specify that the borrowing business maintain "compensating balances," pay a "commitment" fee or the loan itself may be "discounted." And these are only the more frequently encountered costs.

• **Discounted loans:** When a loan is discounted, the interest is subtracted from the total amount of the loan. Thus, the proceeds received by a borrower, and available for use, represent the difference between the face amount of the loan and the stated interest. Discounted loans are usually short-term loans.

• **Compensating balances:** Compensating balances are similar to discounted loans because the bank requires the borrower to leave a portion of the loan in the bank, effectively reducing the amount of funds available for use. Of course, the borrower pays interest on the entire loan.

• **Doubling up:** Surprisingly, a grower could have a loan that's subject to both requirements—that is, the loan could be both discounted and compensating balances required.

• **Insult to injury:** The commitment fee can be assessed in combination with either a discounted loan and/or a compensating balance requirement. When calculating the combined effect of these terms remember to reduce the amount of the loan proceeds available for use and increase the interest cost by the amount of any special charges.

Lost opportunity cost

Before shying away from borrowing, every grower should remember that there are also costs associated with not borrowing. One common misconception is that using savings and investments to finance needed purchases or to keep the business going saves on finance costs.

Consider the owner who lends his or her own funds to the growing business. In this case, the cost, often called a "lost opportunity" cost, is the amount those same funds would have earned had they remained in savings or invested. Today's low interest rates that savings earn might substantially reduce that lost opportunity cost, but it remains a factor to be considered.

Another frequently overlooked cost with not borrowing is that the growing operation may stagnate, be forced to pass up growth opportunities, and even be left in the dust by expanding, modernizing competitors, or those better able to finance increased efficiency.

The new limited deduction

Many growers are discovering they're unable to deduct business interest expenses. No longer deductible are business interest expenses that exceed the sum of business interest income, 30% of the adjusted taxable income of the business and the floor-plan financing interest of the business.

For businesses operating as S corporations, partnerships and limited liability corporations (LLCs) that are treated as partnerships for tax purposes, the limit is applied at the entity level rather than at the owner level. Fortunately, the new 30% limitation doesn't apply to small businesses with average annual gross receipts of $25 million or less.

The TCJA contained another exception that allows real property and farming trades or businesses to make an irrevocable election out of the business interest deduction limitation. These businesses are required to use the alternative depreciation system (ADS) to depreciate property with a recovery period of 10 years or more.

In the eyes of the IRS, a grower is in the business of farming if he or she cultivates, operates or manages a farm for profit, either as an owner or tenant. A farm, according to the IRS, includes livestock, dairy, poultry, fish, fruit and truck farms. It also includes plantations and ranches, as well as orchards and grovers. Whether it includes greenhouse or other growing operations depends on circumstances.

Generally, any business interest that isn't deductible in the current year because of the limitation is treated as business interest incurred in the following tax year. This excess may be carried forward indefinitely.

Debt vs. equity financing

Obviously, borrowing isn't the only way to finance a growing business. In order to expand, grow or even exist, many growers find it necessary to tap a variety of financial resources, broken into two categories—debt and equity. "Debt" involves borrowing money to be repaid, plus interest, while "equity" involves raising money by selling interests in the business.

Which alternative is the most economical—debt or equity financing? According to a report issued by the Joint Committee on Taxation (JCT), "the after-tax effect of debt financing is more favorable than equity financing because of the deductibility of interest." That's right: when it comes to managing debt, the interest paid on borrowed funds—even after the TCJA's business interest limited deduction—is deductible by a business borrower, while funds directed to equity investment are not.

Come and get it

Whether already available or more readily available thanks to the Federal Reserve's pumping more funds into the marketplace, business loans can and will vary by lender and amount. Shopping around to both find a willing—and an affordable—lender involves looking at more than the interest rate.

Now might also be a good time for every business to perform a cost/benefit analysis. A cost/benefit analysis is a decision-making tool often used in making financial decisions. As the name implies, it weighs the costs against the benefits of the decision.

Obviously, taking out a business loan is a big step in today's uncertain economic climate. However, by calculating the cost of all available loan options, every grower will be in a position to make a smart borrowing decision that will help the business grow and prosper for years to come. **GT**

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