Can Anything Good Come from the Outbreak of COVID-19?

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I have no formal training, but even to the uneducated, there is more than enough stress and anxiety to go around to make you doubt in the concept of "silver linings."

And of course, when it comes to silver linings, beauty is in the eye of the beholder.

The silver lining this column will focus on is bank lending rates.

The United States Federal Reserve cut its interest rate to near zero. They also struck a deal with the Bank of Canada (Prime Rate adjusted from 3.95% to 2.95% so far), the Bank of England, the Bank of Japan, the European Central Bank and the Swiss National Bank, to lower their rates on currency swaps to keep the financial markets functioning normally.

Regardless of the lending rates, the business fundamentals are the same – if you borrow it, you must repay it.

It is also a bit of an uphill battle silver lining, as many law firms are debt adverse. But I will never the less make a case for borrowing "cheap" money.

Growth in partners' capital has caused an imbalance in debt to equity ratios. And you might ask, how is this a bad thing? Several developments are converting what was seen by some (clearly your bankers) as a positive to a negative including:

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- The Canadian bar is greying, and partners are looking to retire. Capital accounts, whose growth has been left unchecked, are so large that remaining partners struggle to pay them out. Because often the partner retiring is responsible for large books of business banks are now reluctant to loan the funds required;

- Young partners invited to become equity partners are looking at amounts to buy in that proportionately are out of reach even with friendly bankers (has the makings of a "catch 22" situation); and

- Firms are not paying interest on partners' capital accounts. Disproportionate accounts result in excessive interest-free loans to firms. To say nothing of the poor fiscal personal financial management of having large sums of money earning no return.

In a perfect world, to avoid such a problem, firms would pick a specific date when the repayment of the capital account begins. It should be while the partner is still active, and it is over an extended time frame (i.e., start in their late '50s, over ten years).

But most firms operate in an imperfect world (seemingly increasingly so) and so when they finally focus on the issue need to find alternative solutions with shorter timelines.

The current lending rates provide a window (albeit narrow) for law firms to lock in five-year money (or even seven-year money). This money will enable them to re-balance debt-to-equity ratios, get capital out into the hands of partners for investing in their retirement plans, and to get capital levels to a level that encourages rather than discourages new partner entry.

To create a sense of fairness for disproportionate partner capital accounts, interest at the same rate that the firm borrows at should be paid on the permanent capital account. Permanent capital is the monies that Partners invest in the partnership permanently until they leave versus temporary capital. In essence, this is the amount of a partner's undrawn share of the partnership's income and usually is just a temporary situation.

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I would be remiss if I did not point out the income tax consequences of borrowing to repay excess partners' capital. The interest expense on an equity repayment loan is deductible to the firm like the interest expense on any other debt.

There is no expense offset to the principal repayment of the equity loan. As a result, there will be a difference between the taxable income allocated to a partner and the cash income available to the partner (cash will be lower due to repaying principal out of the firm's profit). In simple terms, the partner will pay taxes on income they will not receive cash for during their time at the firm.

However, for tax purposes, your capital account will increase by the difference each year. When the partner retires and receives no offsetting money for this "tax capital," they have a "capital loss," which forms part of the computation of your net capital loss for the year. You can use a net capital loss to reduce your taxable capital gain in any of the three preceding years or any future year. All partners will get to participate in this tax situation as the cash â€“ tax difference usually is allocated proportionately to income allocation.

Many firms will forgo this opportunity, but those that do act upon it will find a gold rather than a silver lining!

Stephen Mabey is a CPA, CA and the Managing Director of Applied Strategies, Inc. Stephen's focus is on law firms in general and on small to medium size law firms in particular. He has written about and advised on, a wide range of issues including - leadership, business development, marketing, key performance indicators, strategic planning, mergers, practice acquisitions, competitive intelligence, finance, mergers, practice transitioning, compensation, organizational structures, succession and transition planning, partnership arrangements and firm retreats. In 2013, Stephen was inducted as a Fellow of the College of Law Practice Management in recognition of his sustained commitment to the highest standards of professionalism in law practice management. For more information, visit ***appliedstrategies.ca*** *or connect with* ***Stephen Mabey on LinkedIn****.*

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