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Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.

ABOUT THE AUTHOR

Alexander J. Davie is an attorney based in the Nashville, TN area. His practice focuses on corporate, finance, and real estate transactions. He works mainly with emerging companies, venture funds, entrepreneurs, and startups. His firm's website can be found at **www.alexanderdavie.com**.

In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

Even in deals with "yourself," you still need proper legal documents.

One situation I often encounter with small businesses is that sometimes they don't always document the transactions they enter into with their owners and other related parties. For instance, let's say that two owners of a corporation decide that their corporation needs more funding. However, they don't want to invest more equity into the business. They are willing to extend a loan to their company and expect to get paid back over the next few years with interest. Here's how that should work (assuming this company is a C Corporation):

The corporation would make payments of principal and interest back to the shareholders. The corporation would be able to deduct the interest as an expense. The owners would not need to pay taxes on the principal but would pay taxes on the interest. There are no double taxation issues because the interest expense is deducible to the corporation.

Unfortunately, small business owners often don't take the time to properly document transactions like this. They may enter it into their accounting books, but the don't prepare any loan documents, nor do they prepare any board resolution authorizing the company to enter into the loan. After all, from the owners' perspective, this is a loan to "themselves" and it seems like a waste of time and money to have official documents prepared. This can cause a couple of problems down the road.

First, if the IRS audits the company, they will ask to see the loan documents and resolutions authorizing the transaction. When the owners can't produce them, the IRS can (and often does) recharacterize the transaction as a dividend. As a consequence, the loan interest is no longer deductible. Therefore the owners will pay double taxation on the interest.

In addition, depending on the capital structure, the principal payments could also be deemed a taxable distribution, thus causing the owners to pay income taxes on the return of principal (which never would have happened had the transaction been properly documented as a loan).

Another area where this can cause problems is when the owners decide to sell their business or sell an interest in it to outsiders. Failing to properly document earlier transactions can cause problems in due diligence, which any sophisticated purchaser or investor would perform on a business he intends to acquire. The process of cleaning the mess up could be expensive (far more expensive than simply having documents prepared from the outset.)

A loan is just one example of the type of transaction that should be documented even when made between related parties. Another example is leases. Many business owners lease their own property to their business. But if they don't prepare a written lease, the rent payments could be recharacterized as dividends or distributions. Here's a couple of other examples: employment agreements, service agreements, purchases and sales of assets, and sale-leaseback transactions. All of these transactions between a business and its owners should have some level of legal documentation.

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