

INCORPORATION NOT ALWAYS A PLUS FOR THE CLOSELY HELD COMPANY; Business Law

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LAWYERS SETTING up a business have a tendency to recommend incorporation almost as a reflex. Usually this recommendation is based on vague notions of limited liability and tax benefits. For the typical business in the United States, however, which is a small business, a corporation may not always be advantageous¹.

Clients often attach great ceremonial importance to being incorporated. Therefore, incorporation may be desirable solely for this reason if it is not detrimental to the client's interest to use a corporation in lieu of another type of entity. The business owner may be misled, however, into believing the use of a corporation provides certain advantages that are not necessarily available under certain circumstances.

Limited liability is one of the most commonly advanced reasons for incorporation. Theoretically, a corporate shareholder is not personally liable for the obligations of the corporation. This is in contrast to a sole proprietorship or general partnership, in which the business owners are subject to unlimited personal liability for business obligations.²

Despite the theoretical distinction between a shareholder and the corporation, limited shareholder liability is often illusory for a close corporation. In several recent cases corporate officers were held personally liable on contracts entered into on behalf of a corporation.

In *Prececo Inc. v. Youngstrom*,³ a 1990 decision, a corporation forfeited its charter because it failed to submit an annual report and pay the corporate franchise tax. Subsequently, the charter was reinstated. During the forfeiture period, however, a corporate officer entered a contract on behalf of the corporation. The Idaho Court of Appeals held that the officer could be personally liable on the contract if he entered the contract with actual or constructive knowledge of the forfeiture.

In *McLean Bank v. Nelson*,⁴ the Virginia Supreme Court went further than *Youngstrom*. In *Nelson*, a Virginia corporation was automatically dissolved under a state statute that provided for automatic dissolution of a corporation if it failed to file two successive annual reports. During the period of dissolution the corporation president signed a corporate note on behalf of the corporation.

Although the business enterprise subsequently was reinstated as a corporation, the court held that the president could be personally liable on the note. The court noted that somebody had to be liable on the note. Because the corporation could not be liable because of its temporary non-existence, the only party left was the president. The court also stated that the shareholders, directors and other officers might be personally liable based on a partnership theory.

In *Jensen v. Alaska Valuation Service Inc.*,⁵ the president of a close corporation was held personally liable for appraisal services that he requested for the corporation's construction business. The president paid for the services with corporate checks. The court held, however, that the use of the corporate checks over a period of several years did not adequately inform the appraiser that he was dealing with a corporation. Therefore, the president was held personally liable for the services on the theory that he was an agent acting on behalf of an undisclosed principal.

In *Como v. Rhines*,⁶ the president of a chain of retail stores hired the plaintiff as an accountant and agreed to pay his moving expenses. After plaintiff relocated and reported for work, the president informed plaintiff that he did not have a position at the company. The court held both the corporation operating the retail store and the president liable for breach of contract. The court found that the president failed to inform plaintiff that he was acting on behalf of a corporation when he employed plaintiff, and therefore he was personally liable as an agent acting on behalf of an undisclosed principal.

In *Flatiron Paving Co. v. Wilkin*,⁷ a defendant signed a contract with an agent for Tri-County Hangar Co. Defendant failed to disclose that Tri-County Hangar Co. was doing business as Airport Development Corp., a Delaware corporation. The court held defendant liable on the contract. Defendant was liable as an agent acting on behalf of a partially disclosed principal because defendant had disclosed he was acting on behalf of a principal, but he failed to disclose the true identity of the principal.

Tortious liability is the most serious concern for a business because it is unpredictable. The use of a corporation has the most potential benefit with regard to limiting shareholder responsibility for tortious liability attributed to the corporation. Under agency principles an employer may be liable for the tortious conduct of employees. If the business is operated as a corporation that conducts its business via employees, the shareholders are shielded from personal liability.

Aside from the tortfeasor employee, only the employer corporation, under a vicarious liability theory, can be liable for the employee acts. Such shareholder protection may be lost, however, if the shareholder is actively involved in the operation of the business. In a close corporation shareholders are directly involved in the day-to-day management of the business. Any tortious conduct committed by a shareholder renders him or her personally liable as a tortfeasor in addition to the corporation being vicariously liable. Consequently, use of a corporation may only limit a shareholder's liability if the shareholder is merely an investor who is not involved in the day-to-day operation of the business.

Failure of business owners to comply with formal statutory requirements in the operation of a corporation can also negate any liability shield offered by a corporation. Appropriate director and shareholder meetings must periodically be held. Corporate actions must be documented. Annual filings must be submitted to the state of incorporation and other jurisdictions in which the corporation does business. Additionally, the shareholders must maintain a distinction between their personal finances and corporate finances. Separate shareholder and corporate bank accounts must be maintained.

Often shareholders of a close corporation will neglect to comply with these formal requirements. Commingling of personal and corporate funds is not uncommon. Additionally, most corporate statutes have reduced the number and complexity of corporate formalities. In many jurisdictions owners of a close corporation can eliminate the board of directors.⁸ Written consent to corporate action can be used in lieu of required meetings.⁹

The ease of compliance with corporate formalities frequently becomes a Catch-22. Shareholders of a close corporation often view the corporate formalities as unimportant because they can be complied with so easily. In contrast, failure to comply with formal requirements is often critical in a court's decision to disregard the corporate shield of liability and hold shareholders personally liable for corporate obligations.¹⁰ Despite urging by counsel for close corporation shareholders to comply with ongoing formalities many small businesses view such urging as merely an attempt to generate attorney fees. Consequently, a corporation may provide little liability protection if the business owner neglects the requisite corporate formalities.

TAX CONSEQUENCES must always be considered in deciding whether to incorporate. Currently, corporations are subject to a maximum federal tax rate of 34 percent,¹¹ while most partners and sole proprietors are taxed as individuals subject to a maximum federal tax rate of 28 percent.¹² Additionally, use of a corporation can result in double taxation. The corporation must pay taxes on its net income. When this same income is disbursed to shareholders as a distribution or dividend, the shareholder must also pay tax on the income. This may give a distinct tax advantage to the use of a partnership or sole proprietorship in lieu of a corporation.

Most close corporations can elect special S corporation tax treatment, however, which eliminates the income tax due from the corporation and allows income to be passed to the shareholders and taxed at their individual rates.¹³ The result is that business owners are subject to the same federal tax rate whether they operate the business as a sole proprietorship, a general partnership or an S corporation. However, use of an S corporation entails some limitations. The number of shareholders must not exceed 35. Generally, the shareholders must be individuals and not corporations or partnerships. And only one class of shares may be issued by the corporation.¹⁴

This equality of tax treatment between partnerships, sole proprietorships and S corporations can be altered, however, depending on state corporate tax treatment, which varies from state to state. Certain specialized tax provisions and the likely revival of reduced federal capital gains tax treatment could also change this equality by providing tax advantages for incorporation.

If a business suffers a net loss, equality of tax treatment may not exist among partnerships, sole proprietorships and S corporations. Unlike a C corporation, an S corporation's losses that exceed the corporation's earnings may be applied by the business owner against income from other sources. This can also be done if a business is operated as a sole proprietorship or partnership. Unlike a sole proprietorship or partnership, however, the amount of excess losses that can be used is limited to the shareholder's cost basis in his or her S corporation shares or debt instruments.¹⁵

CAPITAL requirements for both start-up and future operations are factors in choosing to incorporate. Assessing and predicting future capital requirements is critical because inadequate capitalization is a major reason going concerns fail. Even if a business is initially owner-financed, successful businesses often require an infusion of outside capital to ensure continued expansion. Outside capital is obtained either by debt financing or by equity financing, which involves sale of an ownership interest in the business.

A corporation is theoretically the best business entity for raising capital. Both debt and equity financing can be used. An unlimited variety of debt and ownership interests can be created, limited only by the imagination of the corporate promoters. Additionally, the existence of organized public markets for the sale of these interests enhances marketability.

These advantages must be balanced against two considerations. First, a public offering of securities to raise capital requires costly compliance with state and federal registration requirements. Second, S corporation tax treatment will be unavailable because of the 35-shareholder limit imposed by S treatment. Consequently, the need to raise capital must be balanced against the tax advantages of an S corporation and the cost of complying with securities registration requirements.

Sole proprietorships and partnerships provide fewer financing options than corporations. Sole proprietorships are generally limited to raising outside capital by private debt financing. Partnerships can rely on both debt and equity financing. Equity financing of general partnerships, however, requires bringing in new partners who buy into the business. The new partner is a co-owner of the business who has management rights and a right to share in the business profits.¹⁶

Securities registration compliance costs are avoided when new partners are added because buying into a partnership is not considered sale of a security. The need for outside capital must be weighed against the willingness to dilute the existing partners' control of the business by the addition of new partners.

This dilution of control can be avoided if a limited partnership is used because the business can sell limited partnerships, which are equity interests that do not provide management rights. Limited partnerships are securities, however, so costly registration is required. Additionally, fewer organized public markets are available for the sale of limited partnerships than for the sale of shares in a corporation.

ESTATE CONCERNS may also affect the decision to incorporate. Death of a shareholder does not automatically effect the corporation. Shares in a corporation are personal property. They are transferred with the decedent's other personal property in accordance with the decedent's will or by intestate succession. Additionally, such shares can be held in joint ownership with a right of survivorship.

In contrast, death of a sole proprietor or a general partner automatically dissolves the sole proprietorship or partnership, respectively. Appropriate drafting of a partnership agreement can provide for automatic reformation and continuation of the partnership. A sole proprietor's will can provide for disposition of his or her business upon death. Additionally, a buy/sell agreement can be drafted to allow for an orderly transfer of a business upon death of the business owner.

If a close corporation is involved, a buy/sell agreement may also be necessary because, like a sole proprietorship or partnership, continuation of the business will depend upon an orderly transfer of the business. Consequently, similar planning and drafting is required for a business to continue beyond the owner's death regardless of whether it is operated as a sole proprietorship, partnership or close corporation.

If the business owns real estate, however, incorporation may be advantageous. If a sole proprietorship or partnership owns real estate in several states or in a state other than the domicile of the deceased partner or sole proprietor, probate of the decedent's estate can be complicated. Normally, a probate proceeding will be required in the decedent's domicile and in other states where the sole proprietorship or partnership owns real property. If a corporation is involved, probate is only required in the domicile of the deceased shareholder without regard to whether the corporation owns real property in other jurisdictions.

Use of a corporation can limit a business owner's personal liability for debts and obligations arising from the enterprise. The agency theories of partially disclosed or undisclosed principal may render an owner of a close corporation personally liable for obligations of the business. Additionally, day-to-day involvement of the business owner in the operation of the business or failure to abide by statutory corporate formalities can also render the owner personally liable for corporate obligations.

If the business earns a net profit and qualifies for S corporation tax treatment, the tax consequences will often be the same whether the business is a sole proprietorship, a partnership or a corporation. In the event the business generates a net loss, a sole proprietorship or partnership may be more desirable.

The source of financing at start-up and in the future is a critical consideration. If public financing is sought, a corporation is the best vehicle because of the wide availability of public markets for corporate securities. Public financing, however, entails tax consequences because S corporation tax treatment generally will be unavailable. Additionally, costly compliance with securities regulation requirements will be necessary.

Estate planning considerations are generally the same whether a business is incorporated or operated as a sole proprietorship. If the business owns real estate, however, in several jurisdictions probate may be simplified if the business is incorporated.

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1. There are about 13 million sole proprietorships, 3 million corporations and 1 million partnerships in the U.S. *See* Beckerman-Rodau, *Selecting a Business Entity for a Small Business: Non-Tax Considerations*, 93 DICKINSON L. REV. 519, 520 (1989).

2. *See* U.P.A. 15.

3. 786 P.2d 606 (Idaho App. 1990).

4. 350 S.E.2d 651 (Va. 1986).

5. 688 P.2d 161 (Alaska).

6. 645 P.2d 948 (Mont. 1982).

7. 725 P.2d 103 (Colo. App. 1986).

8. *See, e.g.*, DEL. CODE ANN. tit. 8, 351.

9. *See, e.g.*, DEL. CODE ANN. tit. 8 141(f).

10. *See, e.g.*, *DeWitt Truck Brokers Inc. v. Ray Fleming Fruit Co.*, 540 F.2d 681 (4th Cir. 1976).

11. I.R.C. Sec. 11 (1989). In certain low-income ranges corporate tax rates are less than tax rates levied on sole proprietorships and partners.

12. I.R.C. Sec. 1 (1989). In a limited income range, the individual tax rate is 33 percent for some taxpayers. *Id.*

13. I.R.C. Sec. 1361 (1989).

14. I.R.C. Sec. 1361 (b) (1) (1989). However, common stock can be issued with different voting rights. I.R.C. 1361 (c) (4) (1989).

15. I.R.C. Sec. 1366(d) (1989).

16. U.P.A. Sec. 18.