



The Importance of Corporate Records

Introduction

Thousands of people own corporations for the purpose of conducting business while limiting liability. What many people don't realize is that the limited liability is effective only if certain requirements are met. One of the requirements to avoid losing the protection of limited liability, also known as piercing the corporate veil, is to hold meetings and keep accurate records. Failure to keep records does not mean certain failure in court or the IRS, but it is definitely a strike against you while defending yourself.

Definition and Requirement

Corporate records are documents prepared by a business to fulfill requirements imposed by law. Under the Model Business Corporation

Act, a corporation shall keep as permanent records, minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation. Records must also be kept of resolutions creating all classes of stock, all written communications to the shareholders, the most recent annual report, and names of shareholders. The form of the requirements require that the records be kept in written form or in a form that can be reduced to writing in a reasonable time and be made available to shareholders or the government, on request.

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A CASE STUDY

In a Tax Court decision, it was decided that an individual was not eligible for losses stemming from an S corporation because he declared bankruptcy. In the case at hand, the taxpayer filed bankruptcy near year end. The taxpayer then attempted to claim the losses from the S corporation on his personal tax return.

The taxpayer claimed the Internal Revenue Code permitted losses on a per diem/ pre share basis. The Tax Court considered this and stated that the Bankruptcy Code is considered first before the per diem / per share rule is valid. Thus the court ruled against the taxpayer.

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Meetings can be held on a regular basis or a special meeting can be called at any time. Regular meetings can have their notice requirement waived. Special meetings generally require notice and the notice must be shown in the corporate records. At a minimum, corporate meetings are required to be held once per year.

Discussion

After reviewing the above requirements, are your records up to par? If you've been in business for 12 years, can you count 12 sheets of paper in your records? If not, let me use an example to illustrate just how the lack of them can be used to cause you problems.

Oftentimes, business owners will use their own personal property for business use. Being that it is being used for business use, it is often indecipherable who owns the property. During a lawsuit to seize assets, any assets contained in the building can be presumed to be business property. In this case, unless the business owner has a corporate record of his personal property being authorized for use by the corporation, it is very likely that the property will be presumed to be that of the corporation's and be subject to the lawsuit.

At other times, corporations will face lawsuits from the public. Corporate records will be seized under a subpoena power of the court. If the corporate records do not exist or have not been kept up, it is too late to produce them. The person suing at that point has another foot forward in proving that your corporation is merely an alter ego of the owner. With this, a court can pierce the corporate veil to attach the owners' personal assets to satisfy claims against the corporation.

IT IS IMPORTANT TO KEEP RECORDS. Granted you will not be legally bulletproof with them, but without them you are a sitting duck.

Solution

There is no requirement or rule stating that records cannot be made for past events. Therefore records can be made of events that happened long ago, from memory.



However, records must be maintained in a particular format. Writing "had a meeting on 4/15/04 to discuss tax problem" is probably not sufficient. There is a near standard format used to show formality both of the record and of the meeting. The format should state the date, time, location, and actions taken at each meeting.

The Center handles records for numerous clients. If you would like for the Center to help you with your records or maintain them, please give us a call. Remember, the law states that you should have corporate records and keep them current!



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Editor's Comment:

Under the US Bankruptcy Code, the debtor's estate includes everything the debtor owns. Included in this are gains and losses from an S Corporation. The result in this case is somewhat harsh given that the taxpayer filed bankruptcy one month too early. Tax planning is key during bankruptcy cases. When dealing with sensitive tax situations, be sure that your bankruptcy attorney is well versed in taxes or another tax professional is employed to deal with the situation(s) as they come up.

Points of Interest

- **What many people don't realize is that the limited liability is effective only if certain requirements are met.**
- **Failure to keep records does not mean certain failure in court or the IRS, but it is definitely a strike against you while defending yourself.**
- **There is no requirement or rule stating that records cannot be made for past events.**

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The Role of History in Valuing Your Business

Most discussions about determining the value of a business, start -- and frequently end -- with an analysis of historical earnings and/or cash flow. Many buyers & quite a few brokers are most comfortable expressing their valuation as a multiple of last year's earnings or cash flow, or as a multiple of the last three year's average cash flow, or as a multiple of the trailing 12 months cash flow. One of the most commonly reported statistics regarding completed transactions is the multiple the purchase price represents when divided by last year's earnings, or cash flow. And most banks seem to rely heavily on historical cash flow when deciding whether or not to finance a particular acquisition.

With all of this emphasis on history, it is tempting to conclude that the selling price of a business is DETERMINED by its historical earnings or cash flow.

From my experience, however, this is not really the case. What the buyer is ultimately buying is the EXPECTATION OF FUTURE CASH FLOWS. While an analysis of historical cash flows can shed light on the volatility or the likelihood of future cash flows, in the end it's the expectation of future cash flows that determine the selling price.

So once again, if you looking for ways to improve the selling price of your business, work on improving its profitability and its cash flow.

If you know of a business owner who's thinking of selling and who might benefit from a free consultation with us, have them contact me, or any of the M&A professionals at www.bradwaygroup.com

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Frequently Asked Questions...



Q: I would like to set up a Subchapter S Corporation. How do I do this?

A: You must first file articles of incorporation with your respective state. Once this is done, IRS Form 2553 must be filled out to make the Subchapter S election

Q: I already own a Subchapter C Corporation. How can I convert it to a Subchapter S Corporation?

A: First, Subchapter S Requirements must be met. For instance, the corporation must have 100 or less shareholders, all shareholders must be citizens of the United States, etc.. Then, IRS Form 2553 must be filed to make the Subchapter S election.

Q: If I open a business and do nothing else to incorporate or create a formal business entity, what type of business am I and what kind of liability protection do I have?

A: If you do not incorporate or create a formal business entity in the state in which you operate, you are by default, a sole proprietorship. Sole proprietorships do not give their owners any liability protection. If you are operating as a sole proprietorship, I would recommend 1) creating some formal business type offered by your state 2) purchasing general liability and product insurance and 3) keeping up to date records to gain the full extent of liability protection.

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