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Business Entities: Selected Chapters form the Accountant's Business Manual

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Selected chapters from the ACCOUNTANT'S BUSINESS MANUAL

AICPA

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- Sole Proprietorships
- Partnerships
- Corporations
- S Corporations
- Securities Regulation

AICPA
American Institute of Certified Public Accountants

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- ☐ S Corporations
- ☐ Securities Regulation

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Accountant's Business Manual

BUSINESS ENTITIES

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PREFACE

The Accountant's Business Manual, originally published in 1987, is a twenty-two chapter looseleaf reference work designed to provide quick access to concise summaries of theory and practice in a variety of business topics. The material in *The Accountant's Business Manual* which is updated semiannually, constitutes a first reference source either for a quick answer or for topical overview leading to in-depth research or expert consultation. It is available from the AICPA order department: 1-800-334-6961 (USA); 1-800-248-0445 (NY).

This Business Entities volume presents four related chapters reprinted from *The Accountant's Business Manual* dealing with the major organizational forms of doing business in the United States—proprietorships, partnerships, corporations, and S Corporations. A fifth chapter on Securities Regulation deals with federal regulatory requirements associated with issuance of stock and securities.

Because the selection of organization is the responsibility of the firm's owners, advisors to business owners must understand the entity characteristics that will aid the organization in achieving its goals and be aware of how those characteristics impact the firm's financial activities. For each entity, the chapters discuss ease of formation, liability of owners, stability, control, and the salient advantages and disadvantages of the organizational form.

Proprietorships. This chapter presents the legal nature of proprietorships, characteristics, and advantages and disadvantages, as well as a proprietorship creation checklist of steps that should be taken by the owner, attorney, and accountant in the formulation of the business. The chapter discusses special requirements before starting up, the nature of coproprietorship, considerations in employment of spouse and children, accounting systems, and conversion to partnership or corporate forms.

Partnerships. This chapter discusses the advantages and disadvantages of the partnership form and the requirements for setting up a partnership. It presents duties and responsibilities of partners to each other and to third parties, distribution of profits and losses, taxation, and partnership termination procedures.

Corporations. This chapter summarizes provisions of the Model Business Corporation Act (and revisions) regarding incorporation procedures, directors, shareholding, inspection requirements, books and records and charter amendments. It includes a planning checklist for incorporation procedures and a tax interview checklist.

S Corporations. The advantages and disadvantages of this Internal Revenue Code-created corporate status are examined, and comparison is drawn to C Corporations. It covers elements of taxation and tax planning at corporate and shareholder level. All changes brought about by the Tax Reform Act of 1986 as well as the Omnibus Budget Reconciliation Act of 1987 and the Technical and Miscellaneous Corrections Act of 1988 are reflected in this chapter.

Securities Regulation. Outlines the content and requirements of the 1933 and 1934 securities acts and other federal securities related acts and describes the accountant's liability under them. It summarizes the contents of a prospectus and specifies situations of exemption from registration. Provides an outline of requirements for initial public offerings.

TABLE OF CONTENTS

CORPORATIONS

S CORPORATIONS

SECURITIES REGULATION

INDEX *209*

SOLE PROPRIETORSHIPS

SOLE PROPRIETORSHIPS

1. INTRODUCTION

Proprietorship arrangements (also known as sole proprietorships) are probably the oldest historical form of conducting business and even today can be the least sophisticated in terms of structure and accounting. Proprietorships are affected by legislation of many sorts. Individuals and their proprietorships are legally synonymous since laws designed to affect a proprietorship also affect the individual operating it.

A proprietorship is a business enterprise in which a single individual—not a partnership or corporation—engages in that enterprise for profit as an owner-operator.

2. LEGAL NATURE OF PROPRIETORSHIP

Legislation affecting proprietorships exists at both the federal and state levels. Uniform business legislation has eliminated many of the inconsistencies that previously existed in state legislation.

2.1 Formalities

No specific formalities are necessary for initiating a proprietorship: The proprietor can merely open the business to the public and announce the nature of the business. Use of a trade name, however, may require filing a certificate of assumed name, as discussed in section 6.1 in this chapter. Consult the appendix checklist at the end of this chapter to determine if permits or licenses are required to commence operations in the selected location.

2.2 Duration

A proprietorship enterprise may endure as long as the proprietor wishes or may be terminated at will.

2.3 Business Purposes

There are no limitations on a proprietorship's business purposes so long as they are not contrary to law.

2.4 Size

There are no restrictions on the size of a proprietorship; even multiemployee, multilocation, high-dollar-volume enterprises can function as proprietorships. As the size of the enterprise grows, however, it becomes increasingly difficult for one individual to maintain unless management personnel have been employed.

3. CHARACTERISTICS OF A PROPRIETORSHIP

3.1 Unlimited Liability

The distinguishing characteristic of a proprietorship enterprise is the foremost interest of the owner-proprietor. Although the proprietor may delegate certain management or administrative functions to employees, the business owner ultimately assumes responsibility for all decisions, acts, or omissions.

The proprietor cannot delegate or contract away personal liability in connection with the enterprise. Any personal assets outside the context of the business remain at all times legally available to satisfy debts, obligations, or tort liability incurred in connection with the proprietorship business. The business owner may make legal transfer of personal assets to a spouse or children to limit exposure in connection with the business.

3.2 Commingling of Personal/Business Assets/Liabilities

Proprietorships frequently commingle personal and business moneys and other property within the business accounts. The business account is often utilized to pay personal expenses, and separation of business assets and expenses from personal items is often difficult. While such commingling is not per se illegal or unethical, a tracing problem with respect both to taxation and to disposition of assets frequently arises. Results of operations may also be distorted or concealed from the owner because of commingling.

3.3 Term

Unlike a corporation or even a partnership, a proprietorship has no continuity as a legal entity beyond its identity and personality and a decision to continue the business enterprise. Once a decision is made to terminate operation, the enterprise terminates. When the business is sold or a divestment is issued as a matter of law, its form assumes a new identity.

4. ADVANTAGES OF PROPRIETORSHIP

4.1 Simplicity

The chief advantage of the sole proprietorship is its simplicity. Accounting and taxation systems tend to be less complex than for other business entities, and the fact that one individual holds all assets and liabilities allows the individual to dedicate more time to the product or service than to bookkeeping or ancillary diversions.

4.2 Owner Control

Another significant advantage of sole proprietorship is the owner's exclusive control of the enterprise. Subject to necessary guarantees of creditors or financing parties, the proprietors are able to make the appropriate decisions and to operate the business as they choose.

4.3 Commingling of Assets/ Income/Deductions

Commingling of assets, income, and deductions between the proprietor's business and nonbusiness effects can be advantageous insofar as deductions and loss from the formative years of a new proprietorship may be helpful in offsetting substantial nonbusiness income of the proprietor. Commingling can be a disadvantage if faulty bookkeeping makes tracing difficult; care must be taken to ensure that provisions of the Internal Revenue Code are not violated with regard to assets used both personally and for business. This is particularly true with respect to "listed property," which has a high likelihood of both business and personal use. Listed property includes automobiles and other vehicles; any property of a type generally used for entertainment, recreation, or amusement; and any computer or related peripheral equipment.

4.4 No Double Taxation

Because of the flowthrough nature of the financial and tax aspects of a proprietorship, double taxation of income does not occur, as it may for a corporation.

4.5 Employment of Spouse/Children

Sole proprietors may employ their spouses and their children in the business enterprise provided they are reasonably compensated for the duties performed. Wage payments to the spouse and children are a legitimate means of advantageously passing business income to the household of the proprietor.

Wages paid to dependent children under eighteen are exempt from the usual employee requirements of Social Security taxation. Prior to 1988, the same was true of wages to a spouse. However, the Revenue Act of 1987 requires that all wages paid to a spouse after 1987 are subject to the same Social Security taxation as other, nonfamily, employees. A further discussion of the employment of family members is found in section 10 in this chapter.

5. DISADVANTAGES OF PROPRIETORSHIP

5.1 Individual Liability

The chief disadvantage of a proprietorship is the lack of a shield from liability. While liability may be mitigated by insurance coverage, the proprietor will, as a rule, retain ultimate personal liability—including exposure of nonbusiness assets to proprietorship liabilities. Legal or financial risk cannot be spread among a number of individuals or entities and thus mitigated. The proprietor's responsibility is total.

The enterprise may outgrow the proprietorship form as the business grows, particularly in the area of employer or employee fringe benefits, where such benefits may be either unavailable or tax-disadvantageous for the proprietorship.

5.2 Lack of Continuity

A sole proprietorship has no continuity of existence, unlike a partnership or corporation. When the proprietor ceases to operate the business, the enterprise ceases to exist.

5.3 Social Security Taxes

With the taxable earnings base continuing to rise, more income may become subject to Social Security taxation than is available to be drawn as salary, particularly where the proprietorship operates in a capital-intensive business.

6. FILING AND COMPLIANCE REQUIREMENTS

6.1 Certificate of Assumed Name

If the enterprise is to be conducted under a name other than that of the proprietor, many states require that a certificate of assumed name be filed in a local office and that public notice, usually in a newspaper in the immediate business area, be provided so that the actual operator of the business can be publicly identified.

If the business name requires some type of protection against infringement, a reservation of that name may be available in a central state office (usually that of the secretary of state).

6.2 Local Licensing and Permits

All jurisdictions have local licensure requirements of varying strictness governing the carrying on of business of any type. Special licensing may be required for liquor, food, drug, restaurant, hospital, tobacco, transportation, and other activities. Inquire at the municipal level to ascertain what licenses must be obtained and to ensure that land-zoning ordinances are not violated.

6.3 Professional Licensing

Any necessary professional licensure or notice requirements for carrying on the planned enterprise must be met, usually through the secretary of state, prior to commencement of business, to assure uninterrupted business operation.

6.4 Sales Tax Permits

In most jurisdictions, provision must be made for collection and payment of state or local sales tax if the enterprise involves the sale or exchange of goods or services that are subject to such taxes. Inquiry should be made of the state revenue department and possibly the municipality to obtain the necessary permits.

6.5 Federal Employer Identification Number (FEIN)

A Federal Employer Identification Number must be obtained if additional persons will be employed, with application made to the Internal Revenue Service on Form SS-4. Some jurisdictions also require a state tax identification number.

6.6 Workers' Compensation

Suitable contact must be made with the local authority administering workers' compensation statutes to ascertain if the enterprise is subject to mandatory coverage and to provide any necessary proof of compliance. (See the chapter on Workers' Compensation, herein.)

6.7 Unemployment Compensation

Appropriate filings with and periodic deposits to the agency administering unemployment compensation programs must be made if the number and type of employees necessitate such arrangements under federal and state laws. Both state and federal unemployment taxes may be involved. Federal unemployment (FUTA) tax must be paid on a quarterly basis, using a Federal Tax Deposit (FTD) card, if the liability exceeds $100. Annual reporting is required on IRS Form 940 by January 31 of the following year. Some employees are exempt from federal employment taxes: Consult Internal Revenue Service Circular E, *Employer's Tax Guide*, to determine necessary coverage. (See the chapter on Unemployment Insurance, herein.)

6.8 Withholding Taxes

Periodic payments and informational filings will be required for employee withholding, income, and employee Social Security tax obligations. IRS Form 941 is used to report federal income and Social Security taxes. The proprietor's Social Security tax liability is computed on the proprietor's U.S. individual income tax return at year end as described in section 6.10. (See also the chapter on Social Security, herein.)

6.9 Other Employment Regulations

Required proof of compliance with local and federal wage/hour, safe-workplace, nondiscrimination, and other fair employment regulatory laws depends on the nature of the business and form of operation. (See the chapter on Employment Regulations, herein.)

6.10 Income Tax Reporting

Proprietorship income is reported annually to the IRS on Schedule C, Profit (or Loss) From Business or Profession, and included in the individual's Form 1040. This income must also be considered in calculating self-employment tax on Schedule SE and possibly on other tax forms included in Form 1040.

The 1986 Tax Reform Act requires the categorization of interest expense, and limits deductibility. Interest expense incurred in the normal operation of a proprietorship business should be fully deductible on the proprietor's Schedule C as business interest expense.

7. PROPRIETORSHIP NAME

As a rule, a proprietorship business may use any name, including but not limited to the name of the proprietor or some variation of that name. Restrictions imposed by state law include names another enterprise has previously protected by a copyright, trademark, or service mark filing or that has acquired a specific secondary identification of its own with the other enterprise through long association. Names indicating or implying obscene or illegal activities or names that would be false or misleading are also normally prohibited.

If there is any question about the use of a name in a proprietorship business, or if the name is so unique or integral to the business that protection of its exclusive use needs to be sought, a trademark or name search should be initiated. If the name needs protection, application should be made for filing it as a unique and identifiable name or mark. Such search and filing should be on both a state and national level—governed, of course, by the need to protect the name and the scope of the business activity.

8. ACCOUNTING SYSTEMS FOR PROPRIETORSHIP

Any accounting system that accurately reflects the income of the enterprise and is appropriate for the particular nature of the business may be used.

8.1 Accounting Methods and Consistency

The accounting method chosen should allow determination of profit and loss under generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). The cash basis of accounting is generally the simplest and can be used by many small businesses. If significant inventories exist, Internal Revenue Code Section 471 requires that the accrual basis be used. Any method used must be consistently followed from period to period.

8.2 Minimum Requirements

The Internal Revenue Code requires that the system used clearly show income and deductions. This normally includes the checkbook and some appropriate record of cash receipts and disbursements that categorizes them by type. The double-entry accounting system greatly reduces the risk of errors in recording transactions and is necessary when using the accrual basis of accounting.

Whether computer-generated or manually prepared, it is essential that the records provide an audit trail from the basic transactions to the amounts used for financial reporting or income tax purposes. All proprietorship business records should be retained for a minimum of five years.

9. HUSBAND AND WIFE AS CO-PROPRIETORS

9.1 Propriety

While a proprietorship enterprise is generally viewed as the responsibility and characteristic of a single human owner, a husband-wife co-proprietorship may be nonetheless viewed legally as a proprietorship rather than a partnership. However, for tax purposes, the IRS ruled in Revenue Ruling 82-39 that a proprietorship by definition can have only one proprietor—the spouse who "substantially controls" based on the facts. Accordingly, the remaining spouse is relegated to employee status, which should be documented by payment of a salary.

Generally, one spouse is designated the actual proprietor of the enterprise for management purposes but both can be equally liable for debts and obligations of the business, and the separate assets of both husband and wife would probably be reachable to meet potential liabilities of the enterprise.

9.2 Divorce

Marriage dissolution often results in dissolution of the enterprise in which the spouses were engaged, or in its alteration to another form. Each spouse may be held to have an ownership interest in the business, its assets, goodwill, and continuing operation; and the business itself may be awarded to a spouse who is not interested in its continuing operation. Alternatively, a divorce court may decide that a property division requires paying cash sums that cannot be raised without the complete disposal of a small business enterprise.

In reaching a property division settlement, a business valuation is typically required. (See the chapter on Business Valuation, herein.) While property transfers between spouses as part of a divorce settlement continue to be tax-free under IRC Section 1041, the tax cost associated with selling the business needs to be considered in reaching an equitable division.

10. EMPLOYMENT OF SPOUSE AND CHILDREN

Family members can be employed by a proprietorship with significant advantages and disadvantages if the salary is reasonable in relation to the services performed for the business. Salary payments should be documented by issuing a Form W-2 and paying the salary on a regular basis. Wages should also have the appropriate federal and state income tax and, possibly, FICA withholdings.

10.1 IRA Deduction

Spousal salary may create a source of earned income to support an additional contribution to an Individual Retirement Account, subject to the limitations imposed by the 1986 Tax Reform Act.

10.2 Keogh/HR 10 Plan Contribution

Spousal salary creates a source of earned income to a spouse to allow Keogh/HR 10 plan contribution after the spouse has met participation requirements.

10.3 Estate Planning

Spousal salary creates a source of earnings to solidify payment by a spouse of life insurance premiums (the spouse often owns insurance on the proprietor's life). It is also a means of building a separate estate in the spouse's name in a regular manner and facilitates separate gifts by a spouse to children. (See the chapter on Estate Planning, herein.)

10.4 Child Care Credit

Child care expenses for children under fifteen eligible for income tax credit are limited to the lower-paid spouse's earned income or $2,400 ($4,800 if there are two or more children).

10.5 Social Security Tax

Wages paid to a proprietor's child under age eighteen (including a foster or stepchild) are exempt from Social Security taxation (see IRS Publication 51). Prior to 1988, a spouse as well as children between the ages of eighteen and twenty-one were also exempt. However, the Revenue Act of 1987 imposed Social Security tax on a spouse and children over eighteen for all wages paid after 1987.

Whether it is still advantageous to pay spousal wages subject to FICA tax needs to be determined on a case-by-case basis. Prior to 1988 a spousal salary permanently exempted a portion of the couple's earned income from Social Security tax, assuming the proprietor's income was under the SECA maximum. In 1988, spousal wages would actually increase the couple's Social Security tax liability beyond what it would be if no spousal wages were paid. For 1988, the FICA rate is 15.02 percent, while the SECA rate is only 13.02 percent. Where the proprietor's income exceeds the SECA maximum, spousal wages subject an even greater amount of the couple's earned income to Social Security taxation.

This alone, however, should not be the only consideration. Normally a spouse will draw Social Security benefits based upon the proprietor's lifetime earnings history. The spouse can only draw benefits based on his or her own earnings history if this exceeds 50 percent of the proprietor's level. In other words, it needs to be determined whether FICA tax paid on the spouse's wages will enhance benefits or have no effect. The proprietor should request a history of earnings and a computation of expected benefits from the local Social Security office. Besides the Social Security benefits issue, it may be appropriate to pay spousal wages to allow contributions to retirement plans, claim the child care or earned income credits, or participate in employee benefit plans. The possibility of a marriage dissolution at some point in the future also needs to be considered. A decision not to pay spousal wages to save Social Security taxes may leave the ex-spouse with no Social Security earnings history on which to eventually draw benefits, even after years of legitimate service to the former spouse's proprietorship.

10.6 Earned Income Credit and Business Loss

If there are dependent children and a taxable loss from the business exists, a spousal salary can enhance the earned income credit by combining the salary with an optional self-employment tax election under IRC Section 1402 (a)(12)(ii). A maximum credit of $851 is available for years after 1986. Limitations exist on the use of the non-farm optional self-employment tax election in terms of frequency of election. For further information, see IRS Publication 533—"Self-Employment Tax" and the chapter on Social Security, herein.

10.7 Employee Benefit Plans

If the spouse can be shown to be a full-time employee, medical insurance, medical reimbursement, and other employee fringe benefit plans can be established, subject to the discrimination rules of the Internal Revenue Code. (See the chapter on Employee Retirement and Deferred Compensation Plans, herein.)

10.8 Salary to Children and Tax Bracket

Wages paid to a dependent child can shift income from the parents' higher tax rates to the normally lower child's rates. Disadvantages may exist if the child is forced to file a return or have certain unearned income taxed at the parents' rate under changes introduced by the 1986 Tax Reform Act. Wages to a child could also result in the loss of the dependency exemption if salary funds are used for more than 50 percent of the child's support.

11. REAL ESTATE IN PROPRIETORSHIP

Real estate used by the proprietorship enterprise may be either purchased or leased.

11.1 Held in Proprietor's Name

The property may be held by the business enterprise, but since the business is not an independent entity, it can convey or hold real estate only in the name of either the proprietor or an agent or employee authorized to sign for the proprietor. Even if an agent of the enterprise has such authority, the property owner or the landlord is likely to require that the proprietor be the named owner of the property, lessee under a leasehold, or personal guarantor of the obligation assumed on real property. Accordingly, a substantial liability risk may remain with the proprietor for the duration of the lease or mortgage term.

11.2 Documentation

To transfer real estate and enforce obligations under leasehold agreements effectively, written documentation is necessary. Informal and oral agreements should be avoided due to the pitfalls discussed in section 12.

11.3 Property Used Both Personally and for Business

Property used partially for business and partially for personal purposes should be accounted for in the proprietorship as the business use percentage multiplied by the property's total cost.

12. CONTRACTUAL RELATIONSHIPS OF THE SOLE PROPRIETOR

Since the sole proprietor is in most instances the ultimate personal guarantor of the business' contractual obligations, the significance of the legal undertakings on behalf of the enterprise is intensified.

12.1 Nonbinding Contracts

In some instances, the law will enforce an agreement that would not otherwise measure up to a binding contract if one party has relied to its own detriment on promises made by the other party.

12.2 Verbal Contracts

As a rule, verbal contracts can be fully as binding as written agreements. Failure to write down the terms of a contract invites litigation, since the parties' recollections of the terms may vary widely at a later time, such as upon default of the contract.

12.3 Written Contracts

Traditionally certain types of contracts—such as for the conveyance of real estate or the sale of items above a specified price—must be set out in writing to be enforceable as contracts, although partial performance of the agreement or detrimental reliance by one or both contractors may negate this requirement.

While business convenience may suggest the use of form contracts, failure to review the language in light of the intention of the contracting parties may have unintended results if there is later disagreement or failure of performance of the contract.

12.4 Breach of Contract

Remedies on breach of a contract include rescinding the agreement, a lawsuit to enforce the terms of the contract itself, or litigation seeking money damages for a failure to perform the contract and resultant loss.

Relationships with debtors and creditors may be more personal in sole proprietorships than in corporations since the lines of responsibility and liability are clearer. Obligations of good faith and timely notice of changes in performance of agreements or changes in the nature or form of the enterprise are necessary to retain and enforce rights either as a debtor or creditor.

The law may not support otherwise-enforceable agreements if the party seeking enforcement has waited too long to enforce its rights or if it has itself engaged in conduct that makes it unfair to award recovery on the agreement.

12.5 Uniform Commercial Code (UCC)

All states have adopted the Uniform Commercial Code (UCC) in some form. The UCC's general purpose is to create a framework for commercial dealing and a process to ensure workable agreements when the parties' understanding on a particular point is silent. It may therefore substantially affect proprietorships, in that the code may govern or affect transactions among merchants and consumers of the proprietorship's goods or services.

Article 2 of the UCC governs the sale of goods, while Article 9 deals with secured transactions. Other articles have to do with negotiable instruments, bulk transfers, warehouse receipts/bills of lading, and securities. The applicability of the various sections is governed by local law.

Article 2, probably the most widely applied to proprietorship enterprises in general, relates to forming contracts, delivery rights and terminology, express and implied warranties (as well as their waiver), allocating risk in a transaction in goods, and buyer and seller remedies when a party breaches contract.

Local law should be consulted on the application of the code's provisions to a specific issue.

13. THE PROPRIETOR AND OBLIGATIONS

13.1 Unlimited Authority

Unlike other forms of doing business, the sole proprietor has unrestricted power and authority to contract and incur obligations on behalf of the business except to the extent that a lender, contractor, or creditor may require endorsement by a co-owner of property held by the proprietor that will be used to secure the obligation. As a rule, management decisions are also in the sole discretion of the proprietor or a designee, even the ultimate decision of whether the business will continue to operate.

13.2 Financial Instability or Bankruptcy

In some instances of financial stress or instability, management decisions may be dictated by creditors, either by requiring the proprietor to provide personal guarantees or security or by the creditor's assuming some of the decision-making function.

Such circumstances may also result in a bankruptcy situation in which ongoing operation of the business may be vested in a trustee, appointed by the court, rather than the proprietor. (See the chapter on Bankruptcy/Insolvency for a detailed discussion.)

14. BUSINESS LIABILITY AND PERSONAL ASSETS

As a result of the uniquely personal nature of the proprietorship enterprise, tort or contract liability extends to the personal, nonbusiness assets of the sole proprietor, regardless of the size and complexity of the proprietorship's operations.

14.1 Personal Guarantees

In the initial stages of capitalization and business operation, the proprietor will generally be required to provide personal guarantees of payment, secured by nonbusiness assets.

One of the risks assumed by the owner for choosing to do business in a proprietorship is the fact that the public dealing with the sole proprietor is generally entitled to reach the deeper pocket (if available) of the proprietor's additional personal assets. The proprietor's waiver or disclaimer of liability is generally not sufficient to protect personal assets.

14.2 Liability Insurance

Insurance coverage for every type of potential liability is of particular significance for the sole proprietor. The amounts and nature of protection will, of course, depend on the nature of the enterprise. (See the chapter on Insurance, herein).

15. PROTECTION OF PROPRIETARY PORTIONS OF BUSINESS

15.1 Unique Knowledge

The irreplaceable element of the proprietorship enterprise is the unique knowledge of the original sole proprietor. It is therefore important that this knowledge be documented to provide a smooth transition of power should the proprietor become incapacitated or otherwise unable to continue in the business.

The proprietor should record this knowledge through written policy and procedure manuals, detailed job descriptions, or other training materials. Another method of protecting such knowledge is to bring competent individuals into positions of authority in the enterprise, which will result in a transfer of knowledge of the unique aspects of the enterprise.

Continuity of the business is not really an attainable goal, however, since withdrawal of the proprietor necessarily constitutes an organic change in the form of the enterprise itself. Some degree of continuity can nevertheless be provided by training and maintaining quality employees in the proprietorship.

The proprietor must therefore give close attention to relationships with key employees. Provision can be made to either eventually sell to such employees or modify the form of the business to a partnership or corporate form, which will assure the continued existence of the enterprise.

15.2 Name

The name of the business can be protected by discretionary filings of the name or other proprietory mark with the state or federal agency charged with such protection, as described in section 7, above.

15.3 Goodwill

Protecting the proprietorship's goodwill can be achieved only by assuring the ongoing quality of the business operation and by delegating proprietorship duties to persons capable of upholding such quality. This result is mandated by the highly personal nature of the proprietorship form itself. Even in a business of great size and complexity, the enterprise is still necessarily involved with the personality and leadership of the proprietor. (Further discussion of goodwill is found in the chapter on Business Valuations.)

15.4 Personal Property

Personal property can be protected by insuring against foreseeable risks. (See the chapter on Insurance, herein.)

15.5 Intellectual Property

Items of intellectual property are protected by patent, trademark, copyright, and licensing arrangement, accomplished by application to and filing with the appropriate agency. To the extent permitted by local law and the negotiations of the parties involved, proprietary control of the intellectual property of the enterprise can be assured by assigning patents or other protective filings to the enterprise itself rather than to individual employees.

15.6 Estate Planning for Proprietorship

The proprietorship enterprise is often the largest asset in a sole proprietor's net worth. Personal estate planning that includes the proprietorship interest and its disposition is another means of protecting the sole proprietor's interest (or that of the heirs) in the business.

Consideration should be given to selling the business on an installment basis to family members or others involved in the business prior to death to protect the value of the enterprise to the proprietor and the heirs. Change to a partnership or corporation, as discussed in the following sections, is another means of easing the transfer and disposition of the proprietor's interest.

16. CHANGE TO PARTNERSHIP

As discussed in the chapter on Partnerships of this manual, a change from proprietorship to partnership entails a number of decisions and formal requirements. Competent legal counsel should be obtained whenever such a move is contemplated.

16.1 Partners' Contribution

The initial task is to choose a compatible business associate who is suitable personally, financially, and professionally to assume a proprietary role as a business partner. The proposed relationship must then be evaluated in light of the likely division of labor and capital that would result from such an arrangement.

Assets and liabilities must be evaluated to determine the capital contribution each member will make to the new partnership. Such valuation should be done at an early stage of the proposed change so that ample time for negotiation is available to each party.

Decisions on how to bring the assets and liabilities of the proprietorship enterprise into the new partnership will normally require negotiation. The newly created entity may assume the obligations and liabilities of the preceding enterprise or they may be retained by the individuals. Depending upon the contributions to be made by the incoming partners, disposition of some existing equipment, inventory, or other assets may be necessary to assure the desired capitalization level and ownership configuration.

16.2 Partnership Agreement

The understanding of the parties should be set out in a formal partnership agreement, defining rights and responsibilities both in financial terms and with respect to the services each partner owes to the re-created enterprise. The agreement should also encompass the buy-sell, operational, and disability provisions and contingencies.

16.3 Tax Consequences

Inasmuch as the partnership form continues the ongoing business of the proprietorship, immediate tax consequences of a transfer to the new entity are generally negligible. Under Internal Revenue Code Section 721, no gain or loss is recognized by the contribution of property in exchange for a partnership interest. However, income may result where one partner contributes assets and another partner, contributing services only, obtains an ownership interest in those assets.

The tax basis of a partner's interest is generally equal to the basis of the assets in the partner's hands, increased by any income recognized at the transfer and decreased by liabilities assumed by other partners.

Investment credit recapture will normally not take place unless the contributing partner's interest in the specific assets falls below two thirds what it was before the transfer.

16.4 Notice to Creditors and Debtors

A change in form of the business enterprise requires notices to creditors and other obligees of the business. Without timely notice, the proprietor may be retaining sole liability for obligations rightfully shared by partners and the partnership itself.

17. CHANGE TO CORPORATE FORM

Incorporating a sole proprietorship entails considerably greater formality than change to a partnership. (See also the chapters on Corporations and S Corporations.) Because of the many formalities required and pitfalls that can occur in incorporating, competent professional personnel should always be consulted. From the standpoint of individual involvement in the ongoing business, the changes may be merely formal, since the corporation may include only family members already involved in the business operation as shareholders. On the other hand, incorporation may bring in key employees as shareholders or go to the point of making public offering of shares in the new organization.

17.1 Reasons for Incorporating

—*Limited liability.* A stockholder's liability extends only to the investment in corporate stock, so personal or other business assets are not at risk. However, it is common in small businesses for the stockholder also to hold positions of management and employment that may entail personal liability for actions performed.

— *Income tax.* Corporate tax rates continue to be lower than individual rates on the first $50,000 of income after the Tax Reform Act of 1986. This allows for splitting income between individual and corporate tax returns to achieve full use of lower tax brackets. However, other factors, such as the tax cost upon liquidation of the corporation, must also be considered.

— *Estate planning.* Ease of transfer of a family business from the senior generation to successor family members is facilitated by incorporating. Full use of the annual gift tax exclusion can be used by transferring a specific number of shares, and members of the family can be stockholders without many of the burdens and restrictions of family partnerships.

— *Employee benefits.* A corporation can establish pension and profit-sharing plans as well as plans that provide health insurance and medical reimbursement plans covering the owner/employer, provided antidiscrimination rules are not violated.

— *Tax elections and accounting methods.* The corporation is a new taxpayer and can thus take advantage of the opportunity to make new tax elections and adopt new accounting methods. The corporation might also consider an election under IRC Subchapter S, whereby many of the tax consequences continue to fall on the individual, rather than on the corporation.

17.2 Valuation

Valuation of the assets of the business becomes even more significant when the proprietorship property is contributed to the corporation. The description and tax basis of the various assets and liabilities contributed must be calculated and made part of the corporate records, and a value must be assigned to the shares to be issued.

17.3 Items for Transfer to Corporation

Assets	
Cash	Amount needed for operation.
Receivables	Identify on balance sheet, even if no tax basis (i.e., cash basis proprietorship).
Inventory	Identify on balance sheet, even if no tax basis, to prevent "assignment of income" attack under IRC Section 482.
Machinery and equipment	Generally automatic to include. May retain and lease to corporation, but watch passive-loss rules under Tax Reform Act of 1986.

Real estate	May transfer to allow land debt to be repaid with corporate after-tax dollars or retain and lease to create retirement income. Real estate rent creates a hedge against inflation and does not reduce Social Security benefits under earnings limit test. Personal retention might also allow creation of passive income to allow deductibility of passive losses.
Liabilities	
Accounts payable	If proprietorship was on cash basis the operating expense payables will be deducted when paid by corporation.
Other liabilities	Must correspond to assets transferred or be business-related. May retain personally to avoid transferring excess liabilities.

17.4 Filings

The more formal requirements to prepare and file articles of incorporation and bylaws must be met, as must local requirements to record doing business as an entity other than a proprietorship in the sole name of the owner. New bank accounts should be opened in the corporate name and all vendors and creditors informed of the name change. Title on vehicles and insurance policies should be transferred to the new corporation.

17.5 Issuance of Stock and Securities

Issuing and recording shares (which must be done by formal delivery of the stock certificates and observing all corporate formalities) may be a relatively simple process or may entail a public offering of considerable complexity, depending upon the nature and scale of the business. The short- and long-term capital needs and structure of the business should be considered to assess the appropriate form of shares to be issued and value of the initial capitalization. Consideration should be given to issuing corporate debentures in addition to stock. In this way cash may be extracted from the business in later years, providing an additional income source to the incorporator. The debentures should carry at least a five–year term to meet the definition of a security and avoid taxable gain at the point of incorporation.

17.6 Tax Consequences

A sole proprietor can incorporate under IRC Section 351 and recognize no gain or loss on the transfer. An incorporation under Section 351 requires three steps:

— Property (tangible or intangible) is transferred to a corporation.

— The transfer is solely in exchange for stock or securities of the newly formed corporation.

— The transferees have at least 80 percent control of the corporation immediately after the exchange.

Taxable gain will result to the incorporator if stock or securities are taken back in exchange for services. Gain can also be recognized if the incorporator receives cash or other boot in the exchange.

Investment credit recapture will not occur at incorporation when substantially all of the proprietorship assets are transferred to the corporation and the transfer is a mere change in the form of conducting the trade or business (see Revenue Ruling 83-65). Should the incorporator later dispose of stock or the assets on which investment credit was claimed personally, recapture will flow to the incorporator.

Incorporation should be viewed as a long-term commitment, because double-taxation will generally occur upon the liquidation or dissolution of the corporation, unless it is an S Corporation at all times.

17.7 Liabilities in Excess of Basis

Under IRC Section 357(c) gain may result to the incorporator if liabilities transferred to the corporation are in excess of the adjusted tax basis of the assets transferred. Gain may also result when liabilities that lack a bona fide business purpose or have a purpose of avoiding federal income tax are transferred.

18. EFFECT OF PROPRIETOR DEATH

Because of the close identity of the sole proprietorship with the proprietor, the death of the proprietor could well also spell the death of the business enterprise. Estate planning and distribution of property upon death is covered in detail in another chapter of this volume (see the chapter on Estate Planning, herein), but the intricate intertwining of proprietor and proprietorship is such that some mention of the issue needs to be made here.

18.1 Intestate Death

If the proprietor dies intestate (without a will) or without some other specific provision for the disposition of property, one of the following could result:

— The business and the assets could pass into the decedent's estate and be temporarily operated by the estate's administrator or designee.

— Business operations could be suspended temporarily while provision is made for their ongoing operation.

— The proprietorship enterprise might have to be sold to pay the amounts due for various liens, the taxes owed in connection with the estate, and the expense of administration.

— The enterprise could pass to a family member who has neither interest in nor capacity to continue the operation of the business, resulting in the ultimate demise or disposal of the enterprise, possibly at a significant loss.

18.2 Strategies for Preserving the Business

The chief consideration remains the ongoing operation and viability of the business enterprise itself, since an interruption of even a day's duration could prove detrimental. As a result, the more detailed the estate plan that can be prepared during life, the greater the possibility of minimizing negative consequences on the death of the proprietor.

18.2.1 Conveyance by will

One method of conveying a business interest is to designate a beneficiary in a will. The beneficiary must be carefully chosen, taking into consideration the individual's capacity to operate the business as well as the cash needs of the estate, which could result in a forced liquidation.

Preparations to convey the business should, if possible, be made prior to the death or final illness of the proprietor, in the hope that a successor could be trained and financial arrangements for sale be made before any urgency to dispose of the decedent proprietor's interest.

18.2.2 Sale or conversion to partnership

Valuation of the proprietorship assets and its goodwill presents a substantial problem in the owner's absence. Therefore, prior to the death of a proprietor, consideration should be given to negotiating a sale agreement with a key employee who possesses special knowledge of the business. Alternatively, consider converting to a partnership with a buy-sell agreement to readily pass the interest in the ongoing operation of the enterprise.

18.2.3 Joint tenancy

Where permitted by law, joint tenancy may be considered as a preservation alternative. Local law must be consulted as to whether such a method of holding the business would render the enterprise something other than a sole proprietorship.

19. DISSOLUTION OF PROPRIETORSHIP

19.1 Bankruptcy

A proprietorship enterprise can be dissolved by bankruptcy—either of the business itself or the personal insolvency and resulting bankruptcy of the proprietor. (See also the chapter on Bankruptcy in this volume.)

19.2 Sale of Business

The proprietorship may be sold as an ongoing business entity, resulting in the altered form of the business by virtue of its new owner. Sale price should be allocated to equipment, inventory, real property or leaseholds, unique licenses, concessions or processes, and goodwill inherent in the ongoing business as well as any items peculiar to the nature of the enterprise itself. (See the chapter on Business Valuation, in this volume.)

19.3 Sale of Individual Assets

Business assets may also be sold piecemeal, without the goodwill of the ongoing business. The more uniquely the enterprise is identified with the name, personality, or services of its proprietor, the less likely would goodwill be a saleable commodity.

19.4 Noncompete Agreements

Covenants or agreements not to compete in the same form of business for a specified time and place may be negotiated separately in the sale of a proprietorship or its assets. Such convenants are governed by relevant state laws and are generally strictly construed in favor of free competition.

19.5 Complete Termination

Termination of a proprietorship is never fully completed until all contracts are cancelled or executed, all obligations of the proprietorship fully paid, and timely notice provided to all creditors or obligors.

All parties dealing with a proprietorship must be informed of a change of ownership in order to prevent ongoing liability to the original proprietor beyond the date of the transfer.

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APPENDIX: Proprietorship Creation Checklist

	Date Required	To Be Done By: Atty	Acct	Prop	Date Finished
1 Select attorney					
2. Select accountant					
3 Select bank and set up separate accounts					
4 Set short- and long-term goals					
5 Prepare current year budget					
6 Negotiate financing arrangements					
7. Determine equipment and inventory needs					
8 Negotiate leases and other contracts					
9. Select business name					
10. Do name check and filing of assumed name					
11 Apply for professional licenses					
12 Satisfy local requirements for license to do business					
13. Apply for federal ID number (Form SS-4)					
14 Apply for sales tax ID number					
15. Determine employment requirements and hiring					
16. Apply for unemployment compensation coverage					
17. Obtain expertise for payroll tax reporting					
18 Set employment terms and benefits/employment contract					
19. Develop job descriptions					
20 Secure adequate insurance coverage					
21. Secure worker compensation coverage					

	Date Required	To Be Done By Atty	Acct	Prop	Date Finished
22. Secure professional or other liability coverage	______	____	____	____	______
23 Develop accounting and recordkeeping system	______	____	____	____	______
24. Develop necessary internal forms	______	____	____	____	______
25 Prepare business procedure manual	______	____	____	____	______
26 Prepare personal tax projection and consider need for quarterly estimates	______	____	____	____	______
27. Order office supplies	______	____	____	____	______

PARTNERSHIPS

PARTNERSHIPS

1. INTRODUCTION

Partnership arrangements in one form or another have existed throughout the history of business. Over the years, much legislation has been passed governing partnership arrangements to add formality and consistency. Uniform partnership provisions among states are common in most areas, eliminating previous inconsistencies in state legislation. The provisions of certain legislation may be invoked or avoided depending on how a partnership agreement is drafted.

In partnership arrangements, two or more entities (individuals, trusts, partnerships, or corporations) structure an agreement to work together to accomplish common business objectives.

2. PARTNERSHIP FORMS

2.1 Partnership

A partnership is an ongoing consensual relationship engaged in by two or more entities to conduct a business and to produce profits that will be divided between or among the parties. The partnership form can be used for any type of lawful business activity.

Because this definition is broad enough to include various forms of business associations, the hallmark of the partnership form is the *intent* shown by the partners to function in this form and to share the common purposes and risks of the enterprise on a consensual and ongoing basis.

2.2 Joint Venture

The primary purpose of a joint venture is for the venturers to share the risks and profits of some specific project or undertaking. As such, a joint venture is distinguished from a partnership in that the relationship is not so general, ongoing, or pervasive as a partnership. Joint ventures are nevertheless generally governed by the statutory and case law applicable to partnerships.

A joint venture is not generally required to file a separate tax return, nor is a joint venture recognized as a legal taxable entity by the Internal Revenue Service. Income from a joint venture must be reported by the participants in the venture; the IRS does not provide specific forms for use by joint ventures.

2.3 General and Limited Partnerships

A general partnership consists of partners who are co-proprietors or co-owners of the enterprise in every sense. General partners share the profits and may share management decisions and control of day-to-day activities of the business. General partners also share the risks of ownership, including financial losses and liability for all phases of the business. Such liability may extend to the partners' personal assets unconnected with the partnership.

A partnership may also be composed of a limited partner or partners, in addition to one or more general partners. Generally, a limited partner does not participate in management functions. Section 303 of the Uniform Limited Partnership Act (ULPA), however, does allow substantial participation in certain areas of control by limited partners. The limited partner's share in profits is determined by the partner's investment and the liability of the limited partner is limited to the extent of that investment in the partnership.

2.4 Family Partnership

Although a family partnership consists solely of family members, it is subject to all the rules applicable to other partnerships.

The Internal Revenue Code, Section 704, limits the ability of a partnership to be used as a vehicle to shift taxable income among family members. The partnership must be a bona fide entity wherein compensation is commensurate with duties or responsibilities, not merely an income-shifting device, in order to be legally recognized.

For example, a husband and wife—or parents and children—may operate a farm as a partnership. Merely doing the chores or helping with the harvest does not establish a partnership, however; the legal relationship must be established.

Profit sharing based on duties alone is not the sole determining factor. A person is recognized as a partner if he or she owns a capital interest in a partnership in which capital is a material income-producing factor, even though no services are rendered. Thus, the partnership may be bona fide if a partner's share of profits is related to the capital contributed, a combination of capital contribution and services, or only services, depending upon whether the partnership business is labor-intensive, capital-intensive, or some combination of the two.

Many family partnerships fail because the formalities are not observed. Entering into a written partnership agreement, maintaining proper books and records, and filing the proper tax returns will help establish the legal relationship necessary.

3. LEGAL STATUS AND CHARACTERISTICS OF A PARTNERSHIP

3.1 Hybrid Nature

In one sense, a partnership is a legal entity with an identity of its own. In this sense, the partnership holds itself out as a business entity apart from the individual personalities of its owners. This identity may be established, and its name protected, through filings with appropriate state agencies. The partnership may sue and be sued as a separate entity and is subject to tax reporting and other requirements.

On the other hand, partnerships are simply conduits which allow income, losses, and other tax incidents to pass through to the individual partners. Liabilities for actions or omissions in the course of the partnership's dealings with third parties also pass through to the individuals. General partners are thus liable to the full extent of their individual or personal resources for partnership activity, and no activity of the partnership is ever undertaken without the full personal guarantee of its individual members.

3.2 Legal Characteristics

3.2.1 Duration

Unless specifically limited by the statements or actions of the partners, the partnership exists for general business purposes. Similarly, unless expressly limited, the duration of business existence of the partnership is at the will of the partners. This differs from the corporate form, where the existence is eternal unless expressly limited. On the expiration of the fixed term of a partnership agreement, the partnership may continue as a partnership at will.

The continuing existence of the partnership, however, is subject to the consensus of the partners. When the partners no longer hold themselves out to the public as a partnership, when one or more partners withdraw or die and are not replaced by the unanimous and mutual consent of the remaining partners, or when partners breach their duties to the other partners, the partnership may technically dissolve. Despite the dissolution, the partners will continue to be liable to third parties unless legally adequate notice is given and the partnership activities have ceased. A partnership has no continuity of life as an independent entity when only one partner remains; the partnership then either acquires a new form or ceases to be.

3.2.2 Jointly owned property

Joint ownership of property used or acquired in the course of business may be one indication that a partnership form of business exists but is neither necessary nor by itself evidence of a partnership.

In many cases, real estate may be held by tenants in common, which provides a form of real estate ownership in lieu of actual partnership ownership.

3.2.3 Profit sharing

The single most significant feature of most partnerships is the division of profits. The Uniform Partnership Act (UPA) identifies a partnership as an association of two or more persons to carry on as co-owners of a business for profit. The actual division of profits is determined by the partnership agreement (see sections 4.2 and 12, herein).

4. LAWS GOVERNING THE PARTNERSHIP

4.1 Applicable Statutes and Laws

The Uniform Partnership Act (UPA) is a comprehensive legal skeleton for the partnership form of business that has been adopted by all states except Georgia and Louisiana. The UPA creates presumptive rules that apply where a subject is not addressed by the partnership agreement. The statute also provides protection to other individuals or entities who are strangers to the partnership that can override provisions of the partnership agreement.

The Uniform Limited Partnership Act (ULPA) governs limited partnerships and has been adopted by all states except Louisiana. The Revised Uniform Limited Partnership Act (RULPA), drafted in 1976, has superseded the ULPA in about half the states.

Another source of external governance of the partnership lies in the case law involving partnership issues, and the applicable reports of state administrative agencies ruling on business activities may affect partnerships as well.

4.2 The Partnership Agreement

A partnership is permitted to create its own law by the use of a partnership agreement, a formal document, consented to and executed by all partners, that generally sets out

— The purpose of the partnership.
— Its duration.
— Its executive, administrative, and capital structure; the financial, administrative, and functional relationship among its partners.
— Procedures for decision-making and resolving disputes.
— Formulas for sharing profits, losses, and liabilities.
— The means of equitably terminating the partnership itself upon the occurrence of various events.

The partners should formally embody the intention of the parties in a written partnership agreement. The formal recitals of the parties to the agreement should specify

— That the partners intend to form a partnership for a legal purpose and that the partners understand and accept the legal incidents of a partnership.
— That the partners intend to share, in some specified fashion, the profits, losses, rights, and obligations of a partnership.
— That the partners have a common interest of some variety in the property to be owned by or contributions to be made to the partnership.
— That the partners specify that they will have either an equal share or specifically delineated duties in the operation of the partnership's business enterprise.

The agreement should express a definite commencement date for the business activity, since this moment may be difficult to discern after the fact.

The acts in commencing partnership business performed by individuals representing themselves as partners or agents bind the partnership itself if those acts are consented to, or later ratified by, the other partners or agents.

4.2.1 Buy-sell agreements

Generally, a partnership has no continuity as an independent entity beyond the ongoing agreement of the original partners. This rule can be varied by the continuing agreement of the existing partners to add new partners—or, in effect, to re-create the partnership at some point by altering the form of the enterprise or substituting a new partner for a previous partner.

Another method of accomplishing this re-creation lies in a buy-sell agreement executed by the partners. This agreement provides for the sale of the partnership interest to the existing partners (or the effective buyout of a partnership interest) upon the happening of certain specified events (such as withdrawal or death). Such an agreement, executed at the creation of the partnership itself, provides for continuation in existence of the partnership association (and serves to protect the ongoing business enterprise) by retaining all partnership interests in only those individuals desiring to carry on the business.

A buy-sell agreement is thus a consensual alternative, executed prior to an event that would otherwise terminate the partnership, that can avert such termination and forestall any adverse consequences of a dissolution of the partnership. The agreement need not be filed in a public office for it to remain the source of the partners' rights and duties.

In the absence of a written agreement, the partners may have an informal agreement that governs the day-to-day functioning of the partnership. A verbal agreement is much less desirable than a written agreement. While a verbal agreement may suffice for commonplace, relatively insignificant transactions, any substantial transaction should be documented. In almost all circumstances, courts will recognize a valid written agreement as binding even when it contradicts an oral agreement.

5. DELEGATION OF AUTHORITY FOR MANAGEMENT DUTIES AMONG PARTNERS

The partnership agreement may contain specific delegation of authority for management duties to the various partners. In the absence of such agreement, each partner has an equal right to participate in the management of the enterprise and conduct the business of the partnership. Each partner also has access to the books of record and account of the partnership, which are generally kept at the site of the principal place of business.

Since all partners have equal authority in the management of the business, any partner would be free to delegate administrative functions related to the operation of the business, but such delegation would be subject to the partners' fiduciary duty to the partners and to the partnership and could result in a dissolution if the delegation constitutes an assignment of the partner's interest. An unauthorized act by a partner or designee may nonetheless bind the partnership if an innocent third party is defrauded or led into a detrimental reliance by misrepresentations of authority.

6. DUTIES OF PARTNERS TO EACH OTHER

6.1 Duties of Partners to Co-partners

The specific duties of a partner to the co-partners or to the partnership itself are defined by the partnership agreement or the understanding of the partners.

A partner is an agent of the partnership, whose actions will bind both the entity itself and the co-partners. A partner has a duty to indemnify co-partners for necessary and appropriate expenditures or debt that the co-partner makes or incurs in the course of the partnership business.

6.1.1 Fiduciary duty

A partner owes to the co-partners and the partnership itself a duty of the utmost good faith and fair dealing, based on the trust and confidence inherent in the partnership arrangement. The law refers to this trust as the fiduciary duty of the partner. As a rule, partners will be held to using their best efforts in carrying out the business objectives of the partnership.

6.1.2 Duty to share profits

Unless varied by agreement, a partner must turn over to the partnership and to the co-partners any profits or advantages directly or indirectly derived from the partnership activities.

6.1.3 Duty to contribute capital

A partner has a duty to comply with the obligation to contribute to partnership capital and, while entitled to return of the contribution and any profits, the partner has no specific entitlement to remuneration for the activities in the business enterprise.

6.1.4 Duty to share losses and liabilities

A partner has a duty to share in losses and liabilities of the partnership as well as not to incur unreasonable obligations binding the partnership or co-partners.

6.1.5 Management duty

A partner has a duty to participate in the ongoing management activities of the partnership and not to withhold such consent as may be necessary for the admission of new partners or for other changes in the structure of the partnership unless prohibited by the partnership agreement. A partner must act for the benefit of the partnership in all the activities involving the enterprise and should not attain personal enrichment at the expense of partnership opportunities. A partner should not carry out an act that would make it impossible to perform the ordinary business of the partnership.

6.2 Remedies for Breach

6.2.1 Court action

Partners are entitled to an accounting of partnership assets, liabilities, income, or losses, to ascertain or protect their own interests in the entity, upon reasonable demand. A partner is also entitled to examine the books of record and account of the partnership. If refused, such accounting may be undertaken and enforced through a legal action. A partner, personally or on behalf of the partnership, may also bring an action for satisfaction of unjust enrichment made by a co-partner at the expense of the partnership.

6.2.2 Dissolution or withdrawal

A partner may petition for dissolution of the partnership upon allegations of breach of trust (fiduciary duty) by one or more of the co-partners and may ask the court to terminate the business relationship and account for and distribute profits and assets.

A partner may declare a personal intention to withdraw from the partnership and, withholding consent to a substitution of another partner or other restructuring of the partnership, cause a dissolution of the business relationship.

7. DUTIES AND LIABILITIES TO THIRD PARTIES

7.1 Express Authority

7.1.1 Binding contracts

Each general partner can make contracts, written or verbal, and bind the other partners and the partnership to the extent allowed under the partnership agreement. A majority vote of the partners is required to grant a partner express authority not granted in the partnership agreement.

Furthermore, some partnership decisions can only be made upon a unanimous vote (including decision to go to arbitration, admit new members, and amend the partnership agreement) unless otherwise provided for in the agreement.

Statements made by a partner acting within the scope of authority as a partner may be attributed to and used against the partnership itself or the co-partners.

7.1.2 Liability for wrongful acts or omissions

The partnership and co-partners are liable for the wrongful act or omission of a partner that causes injury or loss to a third party when the act or omission takes place in the ordinary course of business or the act/omission is authorized by the co-partners.

An individual partner may be personally liable to a third party injured as a result of the partner's act or omission if the partner was acting outside the partner's authority as a member of the partnership.

7.1.3 Conveyance of real estate

A partner can convey title to real estate to third parties, but the conveyance may be voided if the partner was acting outside the scope of authority or the party taking the real estate was aware of the lack of authority. The transfer cannot be voided if the property is subsequently purchased from the original buyer by a person who was unaware that the partner lacked authority in the previous transfer.

Partners who misrepresent themselves are personally liable for credit or other benefits extended by third parties who erroneously believed that authority existed to bind the partnership.

7.2 Implied or Apparent Authority

Implied or apparent authority arises when express authority for a partner to act is not granted in the partnership agreement, but the partner represents to third parties that he or she has such authority, on which they rely. The binding of the partnership in this situation is based on general principles of agency law because of the principal-agent relationship between a partnership and its partners.

This binding of the partnership permits innocent third parties to rely on appearances and thus facilitate the normal course of business. Such liability of the partnership does *not* occur if

— The partner is not authorized to act.

— The third party has knowledge of the lack of authority.

The partnership may also be bound to third parties for a partner's unauthorized actions when

— The partnership or co-partners allow an unauthorized person to misrepresent himself or herself as an authorized agent of the partnership to an innocent third party.
— The partnership ratifies, or approves after the fact, the act or omission by the partner affecting the rights or interests of a third party.
— The acts of the partnership or a partner imply to a third party that a partner is authorized to do something or execute some document on behalf of the partnership and the third party relies on it.

A partner's liability for misrepresentation depends on whether there has been a public or private holding out.

7.2.1 Public holding out

A "public holding out" is a representation that an unauthorized person is a partner in a public manner, in which case any third party who extends credit to the partnership can receive damages from that person even if the third party was unaware of the representation.

7.2.2 Private holding out

A "private holding out" will extend a person's liability only to the extent third parties actually relied on the misrepresentation.

7.3 Notice to Third Parties

As discussed above, third parties may rely upon a partner's appearance of authority. In order to relieve a departing partner from liability or obligation, notice must be given to third parties. Even though the authority of a partner to bind the partnership itself ceases on departure or on the dissolution of the partnership, liability of either the entity or the individual may result if the change is not communicated to the third party.

Dissolution of the partnership or filing of the partnership agreement or an amended partnership agreement in a public office may be insufficient to exonerate the entity or its individual members from liability. Notice should be communicated directly to third parties.

A new partner assumes the liability or obligation of the partnership arising before admission, except that such liability extends only to partnership property. Similarly, a departing partner retains liability on the partnership's obligations beyond the time of departure.

For this reason, the most prudent course is to provide notice to third parties with whom the partnership has dealt in the past of any organic changes occurring in the partnership or in the authority of any of its partners.

7.4 Notice From Third Parties

Notice is a communication by a third party to a partner concerning partnership business. In most circumstances, communication to a partner is also deemed to be notice to a partnership—thereby affecting all partners. Potential problems can arise when different partners actively participate in management but notice is not communicated to all partners.

8. ADVANTAGES AND DISADVANTAGES OF A PARTNERSHIP

8.1 Advantages

A partnership is generally less complex than a corporation in accounting and taxation systems. The partnership form also provides greater flexibility in allocating income and deductions disproportionately. For example, guaranteed payments to partners or specially allocated depreciation are ways in which income can be distributed. Be aware that the Internal Revenue Code contains provisions requiring that allocations of income among partners have substantial economic effect.

Due to the passthrough nature of a partnership, double taxation of income does not occur as it may with a corporation.

8.2 Disadvantages

The chief disadvantage of a partnership lies in the lack of a shield from liability. While such liability may be mitigated by insurance coverage, a general partner will retain ultimate personal liability. Limited partners, however, are able to avoid exposure to personal, nonbusiness assets for liabilities associated with a limited partnership.

The business may outgrow the partnership form, particularly in the area of fringe benefits. The corporate form usually allows better tax advantages for these benefits. Examples of such benefits are medical insurance and medical reimbursement plans.

With the taxable earnings base continuing to rise, it is possible that more income may be subject to Social Security taxation than is available to be taken as draw, particularly when the partnership is in a capital-intensive business. Furthermore, a partnership is not able to avoid Social Security tax on wages paid to a partner's minor children, except under special situations, as is possible under a sole proprietorship.

9. CREATING THE PARTNERSHIP

9.1 Partnership and Limited Partnership Documents

9.1.1 General partnerships

As a rule, there is no requirement that partnership agreements be filed. A statutory provision frequently allows a permissive (nonmandatory) filing of the agreement, amendments to the agreement, or articles of dissolution of the partnership in governmental offices (generally the recorder of deeds or its equivalent) in the jurisdiction of the partnership's principal place of business.

9.1.2 Limited partnerships

Limited partnerships are generally required to file a certificate of limited partnership in a local or state office, specifying a description of the character of its business, its financial structure, and the names and designations of general and limited partners. Amendments and certificates of dissolution must also be filed.

The rationale for the varying treatment lies in the limitation of liability inherent in the limited partnership and the need for third parties to have notice of the character of the individual and entity with which they are dealing.

If the agreement is not filed or is filed improperly, a general partnership will be formed in effect regardless of the partners' intentions to form a limited partnership. Furthermore, if there are misleading statements in the partnership agreement (for example, a misrepresentation of a partner's status), all partners who know of the misrepresentation are liable to reliant third parties for damages even if they are otherwise limited partners.

9.1.3 Advantages and disadvantages

The advantage of filing the partnership agreement lies in the fact that such filing is notice to third parties of the nature of the entity with which they are dealing and may be of some assistance if the authority of a partner is questioned or if someone falsely portrays himself or herself as a partner.

The disadvantage lies in the fact that the partners may not wish to reveal all the details of the internal functioning of the partnership to the world in general through the public record.

9.2 Certificate of Assumed Name

Many jurisdictions require that business enterprises file a certificate setting out any assumed name under which the enterprise will operate and specifying the names and addresses of one or more co-partners. The certificate may then be published in a newspaper in the immediate area of the principal place of business. (Limited partnerships are often required to publish the certificate of partnership as part of the filing requirement.)

Some states require certificates to be filed even if the names used are the actual names of all the partners. Certain professional partnerships may be exempt from this requirement.

Business names receive varying degrees of protection under state and federal law. Searches may be conducted to assure that no similarly named enterprise exists, which might result in confusion. Names may also be reserved prior to commencing business, with protection of names assured by filing in a central agency, generally the office of the secretary of state.

9.3 Federal Employer Identification Number

A federal employer identification number (FEIN) must be obtained by filing Form SS-4 with the Internal Revenue Service. Some states also require a state tax identification number.

9.4 Income Tax Reporting

Partnerships are required to report income annually to the Internal Revenue Service on Form 1065. The tax consequences pass through to the level of the individual partners and are reported in their Form 1040. Self-employment tax will also be levied when an active trade or business is conducted on any income arising from the operational activities of the trade or business. The participation level of each partner needs to be determined each year at the filing of the income tax returns. Where a partner does not "materially participate" in the partnership's business, the partner's share of the income or loss is deemed to be passive for purposes of the alternative minimum tax and regular tax limitations.

Limited partnerships and rental activities are always deemed to be passive.

9.5 Fiscal Year

In general, all partnerships must have the same taxable year as that of the majority of partners, normally the calendar year. If the majority of partners do not have the same taxable year, the partnership must adopt the calendar year.

Existing fiscal-year partnerships are generally required to adopt the calendar year-end by December 31, 1987. Special transition rules for reporting income in the year of conversion are set forth in the Tax Reform Act of 1986.

Under a very narrow set of circumstances, a partnership may apply to the IRS for permission to use a different fiscal year-end for specific business reasons, such as where at least 25 percent of gross receipts occur in the last two months of the fiscal period.

Where specific IRS permission has not been obtained, a partnership may still elect to retain a different fiscal year end. However, electing entities must make a required tax payment by April 15 each year. The required payment is based on the prior year deferral of income reported by the partners. There are two components in calculating the deferral: the Schedule K-1 amount, and the shortfall of the deferral period compensation, rents, and interest. The payment, based on 1 percent over the highest individual tax rate, is refundable if the future "required payment" decreases. There is a four-year phase-in of the required payment through 1990.

9.6 Local and Professional Licensing and Permits

Partnerships, like any other business enterprise, are subject to local, state, and federal licensure or certification requirements, depending upon the nature of the business. There also may be specific local filing requirements for the actual commencement of business. Inquiry to the local agencies involved is always advisable prior to the actual commencement of business since noncompliance could subject the business to penalties.

9.7 Sales Tax Permits

Most states require the payment of sales tax, and partnerships involved in the sale or exchange of goods or services may be subject to the collection and payment of this tax. Application should be made to the state revenue department and, in some cases, the municipality to obtain the necessary permits.

9.8 Unemployment and Workers' Compensation

When the partnership has employees, arrangements should be made with the local authority administering workers' compensation statutes to determine if coverage is mandatory.

Filings and deposits may need to be made with the agency administering unemployment compensation programs if the number and nature of employees of the business meet the requirements under federal and state laws. Accordingly, both state and federal unemployment taxes may be involved. Federal unemployment tax (FUTA) must be paid on a quarterly basis, using a federal tax deposit (FTD) card if the liability exceeds $100, with annual reporting required on IRS Form 940 by January 31 of the following year (see the chapter on Unemployment Insurance in this manual).

9.9 Withholding Taxes

Periodic payments, filings, and informational filings will be required for employee withholding, income, and Social Security tax obligations. IRS Form 941 is required to report federal income and Social Security taxes.

9.10 Amending Required Filings

Any filing requirement must be updated or amended when significant change occurs in the condition of the partnership (with respect to membership, location, or nature of the business, for example), and additional filings are required upon termination of the partnership or of its business operation.

Limited partnerships are generally subject to stricter administrative scrutiny and stronger public filing requirements than other business forms.

10. FUNDING THE PARTNERSHIP

10.1 Contributions of Partners

Some or all partners may contribute to the initial capitalization of the partnership. Contributions may be made to the enterprise in the form of property other than money, or the partner may receive an interest in the partnership in exchange for the performance of immediate or future personal services to the partnership itself.

The time at which a contribution is made is not particularly significant, but the general ledger of the partnership should clearly and accurately reflect the contributions of each partner and the corresponding interest in the partnership itself. Accounting for contributions becomes particularly important when the contribution changes the nature of the business entity itself (as when a sole proprietorship is transformed into a partnership).

10.2 Basis in Partnership Interest

The contributing partner will receive a basis in the partnership interest equal to his or her existing basis in the property. Typically the contribution has no income tax effects, although there are certain exceptions.

10.2.1 Sale of property

The contributing partner may also legitimately make a sale of property to the partnership entity. Any gain would be recognized as income and would also increase the partner's basis in the interest. When the property is material and necessary to the formation of the partnership, the partner's contribution would not be treated as a sale to the partnership.

10.2.2 Interest in exchange for personal services

A partner who receives an interest in property contributed by another may be considered as receiving taxable compensation. The same result may occur when a finder's fee or promotion fee is exchanged for a partnership interest. Compensation results only where services are exchanged for capital interest. A right to share in the partnership profits does not produce income.

10.2.3 Liabilities assumed by other partners

If a partner's personal liabilities are decreased because the other partners have assumed a portion of them, taxable income can result under Internal Revenue Code Section 731 where the distribution exceeds the partner's basis.

11. ACCOUNTING SYSTEMS AND ACCOUNTS

11.1 Accounting Methods and Consistency

The accounting method chosen should allow determination of profit and loss under generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). The cash basis of accounting is generally the simplest and can be used by many small businesses. If inventories are involved, IRC Section 471 requires that the accrual basis be used. Whatever method is employed, it must be followed consistently from period to period.

Internal Revenue Code Section 448 specifies that tax shelters and partnerships with C corporations as partners cannot use the cash method of accounting. Exceptions exist for businesses with average annual gross receipts of $5 million or less, farming businesses within the meaning of Internal Revenue Code Section 263(A)(c)(5), and qualifying personal service corporations.

11.2 Minimum Requirements

The Internal Revenue Code requires that the system used clearly show income and deductions. This normally would include the checkbook and some appropriate record of cash receipts and disbursements that categorizes them by type. The double-entry system of accounting greatly reduces the risk of errors in the recording of transactions and is a necessity when the accrual basis of accounting is used.

11.3 Accounts

As a rule, separate income and capital accounts are set up for each member of the partnership. The partnership may also make provision for draws by any or all partners against the partner's share of the profits of the enterprise. Provision may also be made for payment of interest on that portion of the partner's capital account in excess of the required contribution. Establishment and maintenance of such accounts are generally in the sole discretion of the partners as specified in the partnership agreement.

12. DISTRIBUTION OF PROFITS AND LOSSES

12.1 Ongoing Distributions

As a rule, partners have the right to equal distribution of profits or, generally, of surplus beyond the amount of their contributions in the same fashion as they are liable for partnership losses.

This result may be varied by specific arrangements set out in the partnership agreement or according to the respective percentage of ownership (contribution) of each partner. Profits can also be allocated through guaranteed payments to partners that are treated as expenses of the partnership in determining the remaining distributable income. These guaranteed payments then constitute income to the recipient. The form and time of such distributions is at the discretion of the partnership but must meet the criteria of economic reality.

Where provided by the partnership agreement, a partner may also be entitled to repayment of contributions to the partnership (including interest on contributions in excess of an agreed-upon contribution obligation) and to indemnification by the other partners for payments made or liabilities incurred as an individual in furtherance of the partnership business.

12.2 Distribution on Retirement, Death, or Good-faith Withdrawal

A retiring partner, unless there is a specific agreement to the contrary with the remaining partners, has the right to have the value of the interest in the partnership determined and paid, along with the profits of the partnership attributable to the use of the partner's rights in the partnership property.

Payment of such amounts is a debt of the partnership but is subordinate to the claims of third-party creditors on the individual property of the remaining partners.

The estate or personal representative of a deceased partner has the same rights, except that the estate or the heir of a deceased partner may elect to continue as a partner in a newly created partnership upon dissolution of the original partnership.

12.3 Liquidating Distributions

Termination of the partnership enterprise and liquidation of its assets take place in accordance with the rules and priorities described in section 14 of this chapter.

13. TAXATION OF PARTNERSHIPS

13.1 Conduit Nature of Partnership

Although a partnership is legally viewed as a tax entity (as well as a legal entity) separate and apart from its individual members, the partnership is not itself an income-tax-paying entity. It must, however, file an annual information return, IRS Form 1065.

Profits and losses pass through to the individual partners, as do certain other tax incidents, including the characterization of an asset utilized in the partnership enterprise. In other instances, the partnership is viewed as a separate entity—where, for example, sale of a partnership interest is subject to evaluation for gain or loss, as the taxpayer's shares in a corporation would be.

As a result of the "conduit" or passthrough nature of the partnership for tax purposes, there is no double taxation of partnership earnings, partnership losses can usually be applied against other personal ordinary income of the partners, and items such as capital gains and tax preferences retain their character when passing through to the level of the individual partner.

The partnership agreement is of great significance in ascertaining the intent of the partners to form a partnership, which is important if a taxing authority decides that the enterprise is an association other than a partnership and, for example, taxes the partnership as a corporation.

IRS Regulation 301.7701-2 identifies four criteria that distinguish corporations from partnerships: continuity of life, centralization of management, limited liability, and free transferability of interests. This regulation raises some problems for limited partnerships, although those formed under the ULPA generally qualify as partnerships, not as "associations taxed as corporations."

13.2 Limitations on Passive Activities

A partnership may be deemed passive when the partner does not materially participate in the conduct of a trade or business or if the partnership has rental activities. Rental activities and limited partners are always considered passive whether the partner materially participates or not.

Losses from a partnership's passive activities can only be used by a partner to the following extent:

— To offset other passive income, excluding portfolio income.

— If from rental real estate activities, to offset up to $25,000 of a partner's nonpassive income. However, the $25,000 rental real estate limitation phases out for married taxpayers with adjusted gross income exceeding $100,000.

- Unused losses and credits are carried forward indefinitely and used to offset passive income in succeeding years.
- Suspended losses are deductible in full upon a taxable disposition of the activity.
- Suspended losses are at least partially allowed in the case of a transfer by reason of death.
- The amount otherwise disallowed is phased in as follows:

1987	35%
1988	60%
1989	80%
1990	90%
Thereafter	100%

Special rules apply to oil and gas "working interest" partnerships.

13.3 Limitation on Losses to Amount at Risk

The at-risk rules limit the losses partners may deduct to the amount they had invested in the activity, including borrowed amounts where the partners are personally liable to repay (recourse).

Prior to 1987, the at-risk rules did not apply to real estate holdings. Nonrecourse financing that is secured by the real property may be considered at risk if

- The loan is not convertible debt.
- The loan is from or guaranteed by any federal, state, or local government.
- The loan is from a qualified person (such as an independent bank or financial institution) as defined in IRC Section 465.

A general partnership, by reason of its full-recourse nature, is less subject to "at-risk" than a limited partnership (though still subject to the limitation of loss to the amount of basis).

13.4 Limit on Interest Expense to Carry Investments

An individual is not allowed to deduct interest expense to carry investments to the extent the interest expense exceeds investment income.

Similarly, interest expense to carry an investment in a passive activity must be included with the results of the passive activity. Amounts limited carry forward to future years. Investment interest and passive interest includes interest as a limited partner or interest in other activities in which the partner does not participate materially. (Denial of the deduction is phased in as indicated in the table in section 13.2, above, subject to certain limits for investment interest.)

13.5 Transfers to the Partnership

When property is contributed by a partner to a forming or existing partnership, generally no gain or loss is recognized to either the partnership or the partner so long as the contribution involves cash or property. If the partner makes a contribution of services to the partnership, gain may be recognized to the extent of the fair market value of the interest in the partnership the partner receives in return for services.

As a rule, a partner receives basis in the partnership interest equal to the basis of the property he or she has contributed. For this reason, it is important to delineate in the partnership agreement the exact nature and quantity of interest in the enterprise the partner receives.

Gain may also result to the contributing partner if debt is transferred and assumed by the other partners (see section 10.2, above).

13.6 Distributions and Liquidating Distributions

Partners are taxed on their distributive share of partnership-income items, whether or not any distributions are actually made. Flowthrough of loss from the partnership interest is normally limited to the partner's adjusted basis in the partnership interest in the year the loss occurs.

A liquidating distribution disposes of the entire interest of a partner in the partnership. A partner receiving a liquidating distribution from a partnership generally realizes income only if the moneys received exceed the adjusted basis of the partnership interest. Loss is recognized only if the partner's basis in the partnership interest exceeds cash received plus the basis in inventory and receivables.

13.7 Sale of Partnership Interest

A partnership interest is a capital asset and thus subject to treatment as a capital gain or loss. If sold at a loss, the deduction may be limited in any year to other capital gains plus $3,000 on a joint tax return.

The portion of a sale price attributable to unrealized receivables or to substantially appreciated inventory items is considered to be realized from the sale of noncapital assets. An arms-length sale agreement should specify the portion of the sale price that is attributable to such items based on fair market values according to IRS Regulation 1.751-1(a)(2).

13.8 Termination of a Partnership

A partnership does not terminate for tax purposes by death of a partner, substitution of a new partner, or by the liquidation of a partner's interest.

Termination occurs only when

— No part of the partnership operation is carried on by *any* of the partners; or

— Within a twelve-month period, there is the sale or exchange of 50 percent or more of the total interest in both partnership capital and profits.

A termination is deemed a pro rata distribution of partnership assets, causing recognition of gain or loss to the departing partner and a new basis to the remaining partners.

13.9 Conversion to a Corporation

A partnership may be converted to a corporation by

— Exchange of partnership assets for shares of the corporation.

— A liquidating distribution of partnership assets in which individual partners exchange assets for shares.

— Exchange of partnership interests for shares followed by termination of the partnership.

All such transactions would be viewed as the sale of partnership assets and liquidating distributions in return for the partnership interests. For tax purposes, however, the incorporation may be a tax-free transfer under IRC Section 351. Competent counsel must be consulted in such situations to determine the proper tax treatment.

13.10 Merger of Partnerships

Under IRC Section 708, the merger of two or more partnerships may result in one partnership continuing while the others terminate, or formation of a new partnership with all merging partnerships terminating.

In a merger, the partnership whose members own more than 50 percent interest in both the capital and the profits after the merger will be deemed the continuing partnership. The other partnerships cease to exist.

When more than one partnership qualifies as the successor under this test (for example, partnerships with identical partners), the partnership with the greatest dollar value of assets contributed is the successor.

If all the merging partnerships fail the 50-percent test, all the merged partnerships cease and a new partnership results.

13.11 Death of a Partner

A partnership is deemed to terminate, for purposes of state law, at the death of a partner, and a new partnership deemed to come into existence at the same time. For tax purposes, the partnership is not deemed to terminate.

In the event of termination of the death of a partner, the partnership's taxable year terminates upon liquidation of the partner's interest. If there is no termination, the partnership income of the deceased partner and any liquidating distributions would be income in respect of a decedent.

Subsequent sale of the partnership interest would be a separate taxable event with respect to the estate or to the deceased partner's heirs. (Treatment of estate planning considerations for owners of partnership interests is covered in another chapter of this volume.)

14. TERMINATING A PARTNERSHIP

14.1 Dissolution

Dissolution is the change in relationships that occurs when a partner ceases to be associated with the business. Following dissolution, the partnership may continue in changed form. In all cases in which a partnership is terminated, competent professional counsel should be consulted.

Partnerships may be dissolved upon the occurrence of any of the following events:

— When the business of the partnership or the carrying on of the particular business in the form of a partnership becomes illegal.

— When the partnership acts for an illegal purpose.

— Upon the expiration of the term of the partnership agreement and the mutual agreement of the partners to dissolve the business.

— When any partner or partners declare that they no longer wish to continue the partnership arrangement.

— Upon the death of any partner.

— Upon the bankruptcy of any partner or of the partnership itself.

— When a partner acts to defraud the partnership or otherwise breaks a partner's fiduciary duty to the co-proprietors.

— When a court grants the petition of a partner (or someone acting in the partner's behalf) or of a local or state regulatory authority to dissolve the partnership. Such petition may be granted if—

A partner cannot perform his obligations to the partnership.

A partner has been judicially declared mentally incompetent.

A partner has prejudiced the carrying on of the partnership business or prejudiced the continuing partnership form of the business.

The business of the partnership can only be carried on at a loss.

The court finds other circumstances that make dissolution a fair or equitable result.

Assignment of a partner's interest to a third party does not in and of itself result in a dissolution if the assignment or substitution of a new partner for a former partner is consented to by all the remaining partners.

Dissolution of a partnership may occur by operation of law where, for example, a family partnership is dissolved in the course of the dissolution of a marriage, or where divestment of a partnership interest occurs as part of a marital property settlement under either community property or common law statutory schemes.

14.2 Termination

Dissolution and termination of partnerships are distinguished by the facts that dissolution occurs on one of the above-named events but termination does not take place until the full winding-up of all the business affairs of the partnership is completed. (This winding-up occurs in a much narrower category of situations when the partnership business is to be liquidated.)

Winding-up is a period allotted for the purpose of providing notice of the impending termination to third parties; settling obligations of the partnership to third parties; and adjusting rights, liabilities, and distributions among the partners and their heirs or assigns. Winding-up may take place informally or may be under the supervision of a court that has decreed dissolution. Except as necessary to complete the winding-up of the enterprise's affairs, dissolution removes the authority of any partner to act on behalf of the partnership.

14.3 Termination Not Ending Liability to Third Parties

In line with the purpose of protecting third parties dealing with it, the partnership will be bound by the act of a partner after dissolution by a transaction that would have bound the partnership if dissolution had not occurred, as long as

— The third party had previously extended credit to the partnership and lacked knowledge or notice of the dissolution.

— The third party had prior knowledge of the partnership prior to dissolution and the fact of dissolution was not made as a public notice in a newspaper in the immediate area of the principal place of business.

In other circumstances subsequent to dissolution, partners misrepresenting themselves as authorized representatives of a continuing partnership are personally liable but do not bind the partnership.

Mere dissolution does not terminate the existing liability of any partner unless there is an agreement to the contrary among the other partners, the partner whose liability is in question, and the party to whom the obligation is owed. Barring such agreement, the individual assets of a deceased partner will be subject to partnership obligations that arose while the partner was a member of the functioning partnership.

14.4 Disposition of Assets and Liabilities

Valuation of existing partnership assets may be an issue either in distribution among the partners or in application of those assets to the partnership's obligations to third parties, ordinarily creditors. Recourse to a court's fixing of such values may be required.

At dissolution, partnership assets are disposed of in the following order:

1. Obligations owed to creditors other than partners
2. Obligations owed to partners other than for their capital contributions or profits

3. Obligations to partners for their capital contributions
4. Obligations to partners for profits

If assets of the partnership are not sufficient to pay these obligations, payment is made on a pro rata basis. All obligations of one level must be satisfied before distribution may be made on the next level. Each partner (or representative, if deceased) retains the obligation of contribution to make up deficiencies based on the partnership's debts.

If dissolution has been caused by the wrongful act of a partner, resulting in expulsion, the partner may forfeit the right to any surplus accrued by the partnership to the extent offset by damages and may also be subject to a lawsuit brought by the other partners, based on the breach of the partnership agreement.

When the enterprise has generated losses, obligations arising therefrom are paid first from any surplus, then from the capital accounts of the partners (pro rata), and finally from the individual property of the partners in proportion to their interest in the general partnership.

14.5 Dissolution Where Business Continues

When a partner assigns a partnership interest to a third party, that assignee becomes entitled to the profits owed to the original partner but does not become a full partner with the resultant rights of a co-proprietor.

Dissolution does not automatically require termination. The business may continue in altered form but is not the same entity. The original partnership has dissolved although the business continues to be carried on by another partnership.

When a partnership continues its business enterprise in a new form upon withdrawal or expulsion of one or more partners, creditors of the partnership continue to have the identical rights against the re-created enterprise. If that enterprise is not a partnership but has agreed to assume the debts of the partnership, the creditors will retain such rights against the new entity.

If creditors have not received notice of the change and have acted in reliance on their prior knowledge of the make-up of the partnership, the creditors may retain rights against the individual property of the departing partner or legal representative.

When a partnership continues to transact business beyond the fixed term of its duration or beyond the scope of the business specified in the partnership agreement, third parties without notice may continue to treat the partnership as such and obligations incurred will be viewed as those of a "partnership at will."

15. PENDING DEVELOPMENTS

15.1 Professional Corporations as Partners

Because of the unlimited liability of partners, some partners have been incorporating themselves as professional corporations (PCs). Allowing a PC to be a member of the partnership has led to a growing belief that the individual may be shielded from liability arising from services other members of the partnership have rendered.

15.2 Limited Partnership Tax Shelters

Limited partnership tax shelters, which were developed with the intention of generating passive losses to offset other taxable income, have been altered by every major tax act since 1981. After TRA 1986, which restricted the ability to offset other income with passive losses, a new breed of tax shelters has arisen. Passive income generators, or PIGs, are designed to produce passive income for a taxpayer, which, in turn, would allow losses from other passive activities to be deducted.

15.3 Master Limited Partnerships

A new form of partnership interest called a master limited partnership (MLP) is becoming increasingly popular. Shares in MLPs are publicly traded. The Revenue Act of 1987 requires that MLPs be taxed as corporations.

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APPENDIX: Partnership Agreement Checklist

The following issues should be addressed when preparing a partnership agreement.

1. Names of partners/Name of partnership
2. Date
3. Recitation of capacity to contract
4. Nature of business
5. Principal place of business
6. Capital contributions
7. Contributions in excess of capital
8. Noncapital contributions permitted
9. Devotion of full- or part-time efforts and best efforts
10. Assignment of particular functions among partners
11. Types of accounts
12. Accounting system
13. Designation of banks
14. Designation of accountant/attorney
15. Place of keeping partnership records
16. Duration of partnership
17. Times and decision on profit distributions
18. Rights with respect to drawing accounts
19. Restrictions (if any) on a partner's authority to bind the partnership
20. List of initial property contributions by each partner
21. Schedule of contributions to be made in the future
22. Restrictions on management prerogatives for any partner
23. Provision for majority rule and quorum for voting purposes
24. Periodic partnership meetings
25. Salaries
26. Vacation
27. Sick leave
28. Work hours
29. Specific authority to borrow/incur indebtedness
30. Admission of new partners
31. Provision for expulsion of partners
32. Death of a partner
33. Provision for withdrawal of partners
34. Retirement of partners
35. Proposed sale of interest/buy-sell agreements
36. Fiscal year
37. Dates and procedures for distribution of profits
38. Agreement not to compete upon withdrawal

39. Licensure requirements
40. Insurance provisions
41. Arbitration provision
42. Specific management authority of each partner
43. Specific authority of partners to lend to the partnership or a third party
44. Contribution or indemnification to co-partners for liabilities
45. Amendments to partnership agreement
46. Choice of law
47. Severability clause
48. Filing of agreement and amendments

CORPORATIONS

CORPORATIONS

1. INTRODUCTION

1.1 Definition

A corporation is a formal legal entity established by detailed compliance with a governing statute. A corporation can be thought of as an artificial person, created for the purpose of conducting a business, that can enter into contracts, hire employees, and acquire assets. Corporations are also liable for debts incurred and can be sued.

Characteristics of corporations enunciated in *Morrisey v. Commissioner,* 296 US 344 (1931), are these:

- — Title to property is held by the entity.
- — Management is centralized.
- — Continuity of operation is uninterrupted by death among beneficial owners.
- — Transfer of interest can occur without affecting the continuity of the enterprise.
- — Liability to corporate assets is limited.

1.2 Corporations in the United States

The modern concept of incorporation can be traced back at least to the Roman Empire. The laws that govern modern corporations in the United States emerged primarily during the late nineteenth and early twentieth centuries. Initially, individual state laws designed to regulate the behavior of corporations within their borders varied widely. Today, however, many states have adopted similar bodies of corporation law primarily as a result of the Model Business Corporation Act (MBCA) developed by the American Bar Association. Based on the Illinois statute, the earlier versions of the MBCA have been adopted by many states, though not in their entirety. In 1984 the MBCA was completely revised on the basis of recent revision of the Virginia corporation law, and numerous states are in the process of considering adoption of the revised MBCA. (Reference here will be to the revised MBCA.) Many of the most important corporate jurisdictions (Delaware, New York, New Jersey, California, and Michigan) have not modeled their corporation laws on MBCA, and there are still significant differences from state to state. The federal government has also influenced corporation law with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. Note, however, that there is no federal incorporation statute except for certain corporations such as savings and loan associations.

1.3 Two Important Terms

Relevant terms will be defined as they are introduced, but at the outset of any discussion of the corporation as a business entity it is necessary to understand these two:

— *Publicly held corporation.* A corporation the shares of which are traded on securities exchanges or for which price quotations are published.

— *Closely held corporation.* A corporation in which many of the shareholders participate in management, for which there is no outside market for shares, and in which free transferability of shares may be restricted. Closely held corporations have relatively few shareholders: There is no minimum number of shareholders that a corporation must not exceed to be considered closely held, but any corporation with fewer than fifteen shareholders is generally considered closely held. Several states have special provisions or statutes that apply only to closely held corporations.

1.4 Reasons to Incorporate

The corporate form offers many advantages over other forms of business operation as well as disadvantages. Legal and accounting professionals must therefore thoroughly understand the pros and cons of operating a corporate enterprise and also know the business owners' specific commercial and personal needs. The major advantages of operating a business as a corporation include

— *Tax benefits.* The corporate form provides great flexibility for income tax planning. Corporations have a wide choice in selecting a taxable year. However, for taxable years beginning after December 31, 1986, the Tax Reform Act of 1986 requires S corporations and personal service corporations (PSCs) to adopt the same taxable year as their owners. As a result, many fiscal year S corporations and PSCs have had to switch to a calendar tax year. The Revenue Act of 1987 allows both these taxpayers to elect (on Form 8716) to retain their fiscal years. An S corporation itself must make a "required payment," thus taking away the advantage of tax deferral. (See S Corporations, section 3.4.) Personal service corporations must meet minimum distributions to owner/employees (more-than-10-percent-owners on any day during the tax year).

Owners of corporations can take advantage of fringe benefits not available to owners of other forms of business, such as borrowing from retirement plans and medical expense reimbursement plans. (Medical reimbursement plans became more attractive under the Tax

Reform Act of 1986, which raised the floor for deductible medical expenses from 5 percent to 7.5 percent of adjusted gross income on individual returns.) Although IRC Section 162(m)(1), added by the 1986 act, allows a self-employed individual to deduct, as a business expense, 25 percent of the amount paid for medical care insurance, these expenses are fully deductible for a corporation.

Tax benefits also include group term insurance, accident and health insurance, keyman insurance, major medical insurance, split-dollar insurance, salary continuation plans, 401 (K) plans, SEPs, ESOPs, and so forth.

— *Limited liability.* Because a corporation is a legal entity in itself, the owners of the corporation are not personally liable for debts incurred by the corporation provided that the corporation's creditors realized they were doing business with a corporation. (Many creditors now seek a personal guarantee from shareholders of closely held corporations, thereby eliminating much of the protection of limited corporate liability.) See section 3.3, herein, for a description of how creditors can pierce the corporate veil.

— *Perpetual life.* Since a corporation is an entity separate from the persons who own it, its existence is not threatened by transfer of ownership or the death of an owner.

— *Ease of transferring ownership.* Transferring the ownership of a corporation merely involves transferring ownership of corporation stock.

1.5 Reasons to Liquidate or Elect S Corporation Status

The legal and the accounting professional should review with the small business owner the following tax advantages of sole proprietorship, S corporation status, or partnership over a regular corporation structure.

— *Minimum tax on corporations.* The rate will rise to 20 percent (from 15) and more items will be counted as income in figuring the tax: half the difference between a corporation's book income and its minimum taxable income is a tax preference.

— *Fiscal year.* Personal service corporations must adopt the calendar year as their fiscal year (unless they make minimum distributions to employee/owners; see section 1.4, herein), eliminating a valuable opportunity for owners to defer tax.

— *Distribution following liquidation.* Corporations must recognize gain or loss on a sale or distribution of assets under a plan of complete liquidation. Certain closely held corporations—those with a fair market value of assets of less than five million dollars ($5,000,000) and more than 50 percent of whose stock is owned directly or indirectly by ten or fewer persons who have owned the stock for at least five years—can liquidate by December 31, 1988, and not be subject to this rule. Relief phases out for such closely held companies with values between $5 million and $10 million. Note that, otherwise, the tax cost to liquidate may be prohibitive.

— *Maximum tax rates.* The top tax rates for individuals will be less than the top corporate rate. New corporate rates beginning on or after July 1, 1987, are

Taxable Income	Prior Law	New Law
First $25,000	15%	15%
$25,001–$ 50,000	18%	15%
$50,001–$ 75,000	30%	25%
$75,001–$100,000	40%	34%
Over $100,000	46%	34%*

*A phaseout imposes an additional 5 percent tax on taxable corporate income between $100,000 and $335,000 Corporations with taxable income of $335,000 or more pay tax at a flat 34 percent rate Since the effective date of these rates is July 1, 1987, income in taxable years that include July 1, 1987 is subject to a blended rate

— *Flat tax rate of 34 percent.* For tax years starting after 1987, all taxable income of personal service corporations is taxed at a flat rate of 34 percent. Therefore, there is no tax advantage for owner/employees of these corporations to retain earnings at the corporate level. However, if the Internal Revenue Service characterizes salary payments as "unreasonably high" and thus treats them as dividends, the personal service corporation would pay a tax at 34 percent on the disallowed salary, and the owner/employee would be taxed at a rate up to 33 percent on that distribution.

— *Elimination of preferential treatment for long-term gains of corporations.* Corporate long-term gain is taxed at the same rates as ordinary income.

— *Elimination of individual 60 percent deduction of net long-term capital gains.* There will no longer be an advantage in accumulating earnings in the corporation and then selling the stock to obtain lower tax rates.

— *Elimination of the cash method of accounting.* Corporations other than farming corporations, qualified personal service corporations (those with substantially all activities in the fields of health, law, engineering, architecture, accounting, and so forth), and partnerships with a C corporation as a partner, are not permitted to use the cash method of accounting if the entity has three-year average gross receipts of more than five million dollars.

If a decision is made to liquidate the corporation, the accountant must analyze the substantial tax costs of recapture of investment tax credits, accelerated depreciation recapture, and any gain recognized on sale or distribution of appreciated assets. The costs of disincorporation may be so high that the client should keep the existing structure.

2. INCORPORATION PROCEDURES

2.1 Selection of State of Incorporation

When corporations became popular in the United States, the individual states passed laws to regulate corporate behavior within their borders—laws often designed to make interstate corporation operation difficult. As a result, entities were forced to incorporate in the states in which they planned to do business. Eventually the U.S. Supreme Court struck down many of the state laws, allowing corporations to conduct interstate business with relative ease; corporations can now elect to incorporate in the state that will offer them the greatest benefits. Remember, however, that there are costs involved in operating a corporation in a state other than its state of incorporation (see section 2.6). If the business of a proposed corporation will be primarily intrastate it is usually advisable to incorporate in the state where the corporation's business is to be conducted. Corporations that conduct business in many states may wish to incorporate in a state (for example, Delaware) that has a liberal statute governing incorporation and other matters. Whatever incorporation locale is chosen, people who plan to establish a corporate business entity must retain legal counsel for overall preincorporation advice and aid in preparing and filing the necessary corporate documents.

2.2 Documents Needed to Incorporate

The incorporation procedure varies from state to state, but every state requires that a document be filed with a state official (usually the secretary of state). This document is called by such names as *articles of incorporation* or *charter* (we will refer to it as *articles of incorporation*), but in all cases it is reviewed by the state officer's staff. Pending approval of the document, the corporation's existence is usually deemed to begin on the date and at the time the articles of incorporation were filed and the filing fees paid.

2.2.1 Name reservation

A major item in the articles of incorporation is the corporate name. The rules vary among states, but typically the name must not be "the same or deceptively similar" to the name of any other corporation. To ensure that the desired corporate name is available at the time of incorporation, planners may wish to reserve the name prior to incorporation. Not all states allow the reservation of corporate names, but most allow them to be reserved for a limited time by payment of a nominal fee. In most states, the secretary of state maintains a list of corporate names that are not available. Certain names are not permitted in some states; for example, using the name of a governmental body if the corporation is not connected with it.

2.2.2 The articles of incorporation

The information provided in the articles of incorporation normally includes

— The name of the corporation.

— The number of shares the corporation has authority to issue.

— A clause stating the purposes of the corporation (most contemporary statutes permit a corporation to pursue any legal purpose).

— Name and address of each incorporator.

— The period of duration of the corporation (now almost always perpetual).

— Address of the initial office of the corporation.

— The voting rights of the stock.

— Name and address of the corporation's registered agent.

2.3 Preliminary Procedures

A practitioner assisting a business owner in setting up a corporation should see to it that the following items are obtained:

— A corporate seal

— A corporate minute book

— Blank stock certificates

— A corporate identification number

— A corporate bank account

See the incorporation checklist in the appendix to this chapter.

2.4 The Corporate Bylaws

Any business planning to incorporate must have a set of bylaws to govern the corporation, generally drawn up with the help of an attorney and binding on the members of the corporation. The function of the bylaws is to supplement the articles of incorporation. There are no specific legal matters that must be included in the bylaws, but most have provisions concerning election of directors and officers, quorum requirements, board size, board meetings, and duties of the officers and directors. Bylaws can be changed more readily than the articles of incorporation, often merely by action of the board of directors, because bylaws do not have to be filed with the secretary of state as do the articles of incorporation.

2.5 Doing Business Under a Fictitious Name

Any time a corporation does business under a name other than the name on the corporation's incorporation certificate, it is doing business under a fictitious name (some states use the term *trade name* or *assumed name*). Most states require corporations to file a public notice when using a fictitious name. Currently there is no such requirement in

Alabama	Mississippi
Alaska	Montana
Delaware	Nebraska
District of Columbia	North Dakota
Idaho	South Dakota
Kansas	Tennessee
Louisiana	Wisconsin
Maryland	Wyoming
Massachusetts	

2.6 Foreign Corporations

Corporations are considered "domestic" in the state in which they were incorporated and "foreign" elsewhere. Corporations doing business in states other than their state of incorporation need to register in those states (failure to register usually triggers penalties). It is often difficult to determine what constitutes "doing business" in a particular state, although most accept the MBCA, which provides a nonexclusive list of activities a corporation may engage in without being considered to have transacted business in a state:

— Maintaining or defending any action or suit or any administrative or arbitration proceeding, or effecting the settlement thereof or the settlement of claims or disputes.
— Holding meetings of its directors or shareholders or carrying on other activities concerning its internal affairs.
— Maintaining bank accounts.
— Maintaining offices or agencies for the transfer, exchange, and registration of its securities, or appointing and maintaining trustee depositories with relation to its securities.
— Effecting sales through independent contractors.
— Soliciting or procuring orders, whether by mail or through employees or agents or otherwise, where such orders require acceptance outside the state before becoming binding contracts.
— Creating evidences of debt, mortgages, or liens on real or personal property.
— Securing or collecting debts or enforcing any right in property in securing the same.
— Transacting any business in interstate commerce.
— Conducting an isolated transaction completed within a period of thirty days and not in the course of a number of repeated transactions of a like nature.

All states issue certificates permitting foreign corporations to do business within their borders. A certificate of authority to do business in the state is extremely important to the successful operation of a business and the preservation of its legal rights within the jurisdiction. The nature of business the corporation may do in a foreign state is, however, subject to the laws of and the rights granted by such foreign state. Some state statutes provide that no foreign corporation transacting business in the state without authority to do so shall be permitted to maintain any action or proceeding in any court of such state until the corporation obtains the necessary authorization.

2.7 Deduction of Organization Expenses

Although the costs of organizing a corporation (such as legal fees incident to the organization) are not immediately deductible, Section 248 of the Internal Revenue Code does permit a corporation to elect to amortize organizational costs over a period of not less than sixty months. If the corporation fails to make such an election, the organizational expenses will probably not be deductible until final dissolution of the corporation.

3. CORPORATE DIRECTORS AND OFFICERS

3.1 Directors

Corporate bylaws normally specify the number of directors the corporation must have. Certain states may specify a minimum number of directors in relation to the number of shareholders. The MBCA states that there are no qualifications for a director and a director need not be a shareholder, but a corporation can specify qualifications for directors in its articles of incorporation. The directors are elected annually by shareholders. Many states require that "the business and affairs of the corporation shall be managed by the board of directors." While *business and affairs* does not specify particular duties for the directors, the directors' powers generally include

— Overseeing the daily activity of the officers of the corporation.

— Declaring dividends.

— Formulating corporate policy.

— Authorizing contracts involving the corporation.

Directors need not be compensated financially for their services as directors, although many corporations do so and the trend is toward compensation of outside directors.

The MBCA permits directors to fix their own compensation. Directors can be sued in their capacity as directors, and the directors of a corporation should ask the corporation to carry malpractice (officer and directors' liability) insurance for them. Recently, in an effort to assist corporations facing the prohibitive expense of carrying malpractice insurance, thirty-three states have allowed limits to be placed on the personal liability of outside directors charged with negligence.[1] The laws apply only to directors, not to officers. It does not apply to breaches of so-called duty-of-loyalty situations where, for example, a director might

[1]The thirty-three states are Arizona, Arkansas, California, Colorado, Delaware, Georgia, Idaho, Indiana, Iowa, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, Montana, North Carolina, Nevada, New Jersey, New Mexico, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin, and Wyoming.

have a conflict of interest; nor does it apply to intentional misconduct or illegal activity. In addition, in Delaware, shareholders of several large corporations have overwhelmingly complied with requests to forfeit their right to sue directors for some forms of negligence.

3.1.1 Directors' meetings

State statutes may specify at least one meeting per year. The frequency and location of directors' meetings are customarily set forth in the corporation's bylaws, but they may be left to the discretion of the directors. Directors' meetings are classified as regular and special.

— *Regular meetings*, the regularly scheduled directors' meetings, may be held without first issuing a notice.

— *Special meetings*, any directors' meetings other than regular meetings, cannot be held without first issuing a notice as specified in the bylaws.

The bylaws of a corporation typically set the minimum number of directors who must be present at a meeting for the board of directors to act: a quorum. State statutes may often *set* a quorum requirement. If a quorum is not present, the directors cannot act unless they are in the process of filling a vacancy, in which case fewer than a quorum may be permitted to act. With the advent of telecommunications, many corporations now hold their directors' meetings by teleconference (not all states permit this). Many states allow directors to act without a meeting unless the bylaws of the corporation prohibit such action.

3.1.2 Director's right of dissent

If a director of a corporation feels that the majority of board members are acting in a questionable or risky manner, he or she may choose to file a written dissent. Such a dissent eliminates any personal liability the director might incur as a result of the action by the other directors, provided that the dissent is recorded in the minutes of a meeting or sent by registered mail to the secretary of the corporation immediately following the meeting.

3.2 Officers

The officers of a corporation are elected by its directors. The offices and their duties are set forth in the corporate bylaws and vary from corporation to corporation. In general, however, the four major offices are president, vice president, secretary, and treasurer.

The president is the primary executive officer of the corporation and usually controls the corporation's business affairs. The president has the prerogative to hire and fire employees. In the event of the president's absence or death, the vice president is authorized to perform the duties of the president. Customarily, both the president and the vice president have the authority to execute share certificates and other corporate instruments.

The duties of secretary vary among corporations but generally involve keeping the corporate records and seeing that all corporate notices are timely given to all persons specified in the bylaws. The treasurer is responsible for keeping accurate records of all monetary transactions that affect the corporation, and is responsible for the administration of federal and local withholding and sales taxes and payments to appropriate jurisdictions.

3.3 Piercing the Corporate Veil

The term *piercing the corporate veil* refers to the equitable doctrine by which courts can ignore the fact that a corporation is a separate legal entity and hold the shareholders of the corporation personally liable for the actions of a corporation. Generally, in order to accomplish this the party seeking to pierce the veil must show that the corporation was used for an improper purpose. Acts of fraud, bad faith, or failure to observe corporate formalities (see section 4.5 of this chapter) can also often lead to piercing of the veil.

4. MINUTES, MEETINGS, AND SEAL

4.1 Minutes

Every corporation should keep a volume called a minute book (some states require it), which should include the articles of incorporation in their entirety and any subsequent amendments. In addition, these items should be added to the minute book as they occur:

— Minutes of all directors' meetings

— Time and place of any directors' meetings

— Names of all persons present at any directors' meetings

— Minutes of any shareholders' meetings

— The number of shares represented at any shareholders' meeting

— An indication of whether the meetings were regular or special

— An indication of how any special meetings were authorized and a record of any notice given

Typically the secretary of the corporation maintains the minute book.

4.2 Meetings

4.2.1 Shareholders' meetings

A corporation's bylaws should include a section containing the rules governing shareholders' meetings. If the bylaws are silent, state statute may control and may also set standards for meeting procedures. However the bylaws should cover

— A specified location for holding meetings, often left to the discretion of the directors (some states require that shareholders' meetings be held in their state if that is the state of incorporation).

— A specified date and time for the annual meeting of shareholders (including a provision for adjustment when the annual meeting falls on a legal holiday and a clause stating what should be transacted at such meetings).

— Specification of who is authorized to call for special meetings of shareholders and under what circumstances they may call them.

— Policy for notice to be given before holding a meeting, including a specified method of giving notice.

— Number of shareholders that constitutes a quorum.

— Requirements for meeting adjournment and the procedure for giving notice thereof.

— Specification of the voting rights of the shareholders at the meeting.

— Policy regarding shareholder action without a meeting.

— Policy regarding proxies representing shareholders at meetings.

4.2.2 Directors' and committee meetings

The corporate bylaws should include sections governing meetings of directors and of any special committees. For most corporations these sections will be very similar to the sections governing shareholders' meetings and will cover the items discussed in section 4.2.1.

4.3 The Corporate Seal

While a formal corporate seal is no longer required in all states, most corporations choose to have a die-cast seal. Use of a corporate seal helps distinguish between corporate transactions and personal transactions. Examples of items to which the corporation should affix its seal include corporate resolutions to open bank accounts, share certificates, debentures, bonds, and important contracts (such as real estate deeds, mortgages, and the like).

4.4 Corporation's Bank Accounts

One of the first things a corporation does is open a corporate bank account. Often, the first use by a corporate officer of the corporate seal is on the bank's resolution designating depository of funds.

4.5 Corporation Formalities

The failure to follow corporate formalities can endanger recognition of the corporation's separate existence (see section 3.3). Following are some of the formalities:

— Shareholder approval of the actions of officers and directors should be reflected in the minutes of annual meetings of shareholders.

— Director approval of the actions of officers should be reflected in the minutes of periodic meetings of directors.

— Officer action should be pursuant to resolutions and policy enunciated in the minutes of meetings of directors and shareholders.

— Complete corporate and financial records must be maintained.

5. SHARES

5.1 Definitions

5.1.1 Equity securities

Equity securities represent equity in a corporation, and persons holding equity securities of a corporation are considered to have an ownership interest in that corporation. The three classes of equity securities are:

— *Common shares.* Holders of common shares have residual ownership interest in the corporation that issued the shares. The common shareholders elect the directors of the corporation and are entitled to dividends out of the corporation's earnings as declared by the directors. Upon dissolution of the corporation, holders of common shares are entitled to a per-share (normally pro rata) distribution of the corporate assets remaining after creditors and holders of senior securities have been satisfied.

- *Nonvoting common shares.* Some shares of common stock specifically exclude the power to vote. Not all states permit the issue of nonvoting common shares; some allow holders of nonvoting common shares to vote as a class on issues that affect them as a class.
- *Preferred shares.* Preferred shares are securities senior to common shares, and holders of preferred shares therefore have preferential rights to dividends and the assets of the corporation upon liquidation ahead of common shareholders. However, preferred shareholders are only entitled to a specified amount of dividends or assets upon liquidation, most commonly do not vote for the directors of the corporation, and do not participate in the management of the corporation. (If their dividends have been omitted, preferred shares may provide for voting and management rights.)

5.1.2 Par value

The *par value* of a stock is the dollar value of that stock as stated on the stock certificate. (Stock can be issued with no par value.) The par value of a stock is of very little importance; the actual price paid for the stock will vary depending on market value. The price for a stock with a stated par value must, however, be set at or above par value. In most states, a person who buys stock for less than par value (see section 5.1.5) is liable to the corporation that issued the stock for the difference between the price paid for the stock and its par value.

The MBCA eliminates the concept of par or stated value as applied to discount share problems. The board issues shares for fair value.

5.1.3 Debt securities

A corporation may raise large amounts of long-term capital by issuing *debt securities.* Bonds payable are secured by assets (if any) and are secured by the general credit of the corporation, which assumes the responsibility for repaying the investor the amount of the investment at a maturity date plus annual interest. In contrast to equity securities, debt securities usually provide investors a fixed return that is not dependent upon the success of the company. Bondholders do not have voting rights and do not participate in corporate earnings. Almost all bonds are *callable* so that corporations can pay off the debt prior to the maturity date.

5.1.4 Treasury shares

Shares of capital stock a corporation has issued and subsequently reacquires are referred to as *treasury shares.* Treasury shares are counted by the corporation as shares fully paid and issued but not as shares outstanding. Treasury shares do not vote or receive dividends, cash or other assets upon dissolution of the company. The MBCA eliminated the concept of treasury shares. It provides that repurchased shares are restored to unissued status and may be reissued unless the articles of incorporation prohibit reissue of acquired shares.

5.1.5 Watered stock

The term *watered stock* refers to three types of stock that are issued by a corporation as fully paid in, when, in fact, they are not fully paid in. The three classes of such shares are as follows:

— *Bonus shares.* Par value shares issued without further payment when a shareholder has fully paid for shares of another class.

— *Discount shares.* Par value shares paid for by cash issued at less than par value.

— *Watered shares.* Par value shares issued for property valued at less than par value. Watered shares usually occur when the promoters of the corporation convey property to the corporation at an inflated value in payment for the shares of the corporation. The issuance of watered shares may impose a liability on the recipient equal to the amount of the shortfall from par value.

5.2 Authorized Shares

The number of shares a corporation is authorized to issue must be stated in the corporation's articles of incorporation. There are no limitations to the number of shares a corporation may authorize and there is no minimum number of shares that actually must be issued. Remember, however, that some states base franchise and stock taxes on the number of shares authorized. Even so, it is still advisable for corporations to authorize more shares than they plan to issue in case the corporation has to raise additional capital (and thus can issue additional shares without amending their articles of incorporation).

5.3 Shares Issued

The capitalization of a corporation is based on the shares of stock the corporation issues and the capital it receives in return. The capital the investors provide in return for shares of stock is referred to as *contributed capital.* In addition, some states allow shares of stock to be issued in return for property or services provided to the corporation.

5.4 Consideration for Shares

People often wish to acquire shares of stock by promising future services to the issuing corporation or by giving the corporation a promissory note. (Many states do not allow such transactions or allow them only if the promise or promissory note is backed by collateral other than the shares of stock issued in exchange for them.) The MBCA allows promissory notes and contracts for services to be performed. Shares issued for services are taxable upon receipt.

5.5 Preemptive Rights

Shares of stock can give shareholders specific preemptive rights that are set forth in the corporate articles of incorporation. Typically the article issuing preemptive rights reads: "Every shareholder upon sale for cash of any new stock of this corporation of the same kind, class, or series as that which he already holds, shall have the right to purchase his pro rata share thereof at the price at which it is offered to others." Preemptive rights are often used to prevent dilution of a shareholder's voting strength.

6. SHAREHOLDER AGREEMENTS

6.1 Pooling Agreements

A pooling agreement is an agreement among a group of shareholders in a corporation to vote in a certain manner on certain matters. The method of voting can be specified in the agreement or can be discussed and decided on prior to the vote on the matter in question. For example, a group of minority shareholders can agree to vote collectively against a proposed change detrimental to them as a group. Some states have statutes that regulate pooling agreements, but most do not. If disputes arise among shareholders in a pooling agreement, an outside arbiter usually resolves the disagreement.

6.2 Voting Trusts

The major difference between voting trusts and pooling agreements is that in a voting trust legal title to the shares involved is vested in the trustee. When the corporation records the names of its shareholders, the shares vested in the trustee(s) are recorded in the name(s) of the trustee(s). This does not prevent the equitable owners from receiving dividends on their shares, but the voting rights of the stock are given to the trustee. Voting trusts ensure that all shares of stock held by the trustee will be voted in the same manner. In certain states, if the trustee does not properly exercise fiduciary duty according to the trust agreement, the courts could entertain an action against the voting trust. In contrast to pooling agreements, the shareholders have no way of resolving disputes that arise concerning how the stock will be voted. All states recognize the validity of voting trusts, but many states regulate them as follows:

— The agreement may not extend beyond ten years.

— The agreement must be in writing.

— A counterpart of the agreement must be deposited with the corporation at its registered office, to be subject to the same right of inspection by shareholders or holders of a beneficial interest in the trust that is provided a shareholder to inspect books and records of the corporation.

— The shares subject to the trust must be transferred to the trustee or trustees.

Voting trusts that do not comply with all statutory requirements are considered invalid by the majority of states.

6.3 Share Transfer Restrictions

Many closely held corporations place share transfer restrictions on their stock to prevent shares from falling into unfriendly hands. Typical restrictions include

— *Options.* The corporation must be given the option to buy the shares at a specified price before the shareholder sells them to an outside party.

— *Buy-sell agreements.* The corporation or its shareholders must purchase the shares of any shareholder wishing to sell them. In the case of the death of a shareholder, the corporation must buy the decedent's shares (usually funded by a life insurance policy).

— *Right of first refusal.* The corporation or its shareholders must be given the chance to equal the best bona-fide offer that a shareholder wishing to sell shares has been able to obtain from outside parties.

Corporations that impose share transfer restrictions must state that fact conspicuously on the shares themselves. If this is not done, the share transfer restrictions will be unenforceable.

7. SHAREHOLDER REMEDIES

7.1 Definitions

Shareholder action against a corporation generally falls into one of three categories:

— *Direct action.* A suit filed by a shareholder against the corporation. Direct action can be taken by a shareholder with a claim based on an ownership share in the corporation (if, for example, the shareholder claims entitlement to dividends that have not been paid to him or her).

— *Class action.* A direct action in which a class of shareholders acts to cure or prevent a wrong from befalling that class of shareholders.

— *Derivative action.* An action taken by one or more shareholders as an effort to cure or prevent a wrong from befalling the corporation. Derivative actions by shareholders are subject to various restrictions discussed in section 7.2.

7.2 Restrictions Governing Derivative Suits

Certain prerequisites must be met before shareholders can take derivative action against a corporation:

— The shareholders must make an effort in good faith to resolve the problem by negotiating with the corporation's directors.

— The shareholders must make an effort in good faith to resolve the problem first by getting the directors of the corporation to remedy the situation, a requirement that does not apply to shareholders who can show existence of an adequate reason for not making such an effort. (For a complete description of reasons that are considered adequate consult Rule 23.1 of the *Federal Rules of Civil Procedure.*)

— Most states require that the shareholders taking the action must all have been shareholders in the corporation at the time the action causing the wrong took place. Pennsylvania, Illinois, and California permit suit by a noncontemporaneous shareholder, at the discretion of the court.

— The plaintiff shareholders may be required to post a security bond for reasonable expenses incurred by the corporation or other defendants involved in the suit. (The MBCA has eliminated the security requirement.)

The recovery, if any, in a derivative suit is usually paid to the corporation, not to the individual shareholders.

8. CORPORATE DISTRIBUTIONS

8.1 Definitions

One crucial decision facing the directors of a corporation is whether to distribute any or all of the corporation's profits to the shareholders in the form of dividends. The more common forms of dividends provided by corporations include

- *Cash dividends.* Cash distributions paid to shareholders out of the profits of the corporation, usually expressed in terms of dollars and cents per share or as a percentage of the stated value of the share.
- *Property dividends.* Distributions of the corporation's assets other than cash or stock shares to the shareholders of the corporation.
- *Stock dividends or share dividends.* Distributions of additional shares of stock in the corporation issuing the dividend, usually expressed as a ratio.

> *Example*: If a corporation declares a 25-percent stock dividend, the shareholders of the corporation are entitled to a 25-percent increase in stock: one additional share for each four shares owned. A shareholder who owns fewer than four shares or a number of shares not divisible by four will either receive a cash payment equal to the fair market value of the shares or a fractional share or a scrip (a fractional share with no voting or distributional rights).

8.2 Shareholders' Rights to Dividends

As a general rule, dividends declared by a corporation are a debt of the corporation and may not be revoked by its directors. Dividends are normally payable to shareholders on a specified date; if no date is specified, the shareholders are entitled to the dividends on the day dividends are declared by the directors of the corporation. If shares are transferred after the specified dividend payment date, purchaser and seller must agree on who is entitled to receive the dividends; the corporation will simply pay the dividends to the owner of record on the date the dividends became payable.

To ensure that corporations are paying dividends out of the earnings instead of capital, states have placed certain restrictions on the declaration of dividends. The specific restrictions required by the various states differ greatly, but all states require that any corporation declaring dividends be solvent so that the transfer of corporate assets to the shareholders does not harm the corporation's creditors.

8.3 Dividend Strategies: Publicly Held vs. Closely Held

8.3.1 Publicly held corporations

Publicly held corporations, especially large ones, generally pay dividends on a periodic basis. Payments made by these corporations tend to be stable from period to period, often geared to a percentage of earnings over some period of time.

8.3.2 Closely held corporations

Reinvestment of earnings can be used to finance the internal growth of a corporation. This will be reflected in appreciation of the book value of capital stock. Closely held corporations often prefer not to pay dividends for tax reasons because dividends are not deductible to the corporation. They often distribute earnings as salaries or interest, because these would be deductible but, if the goal of the owners is to sell the corporation, earnings are generally allowed to accumulate. Section 531 of the Internal Revenue Code imposes a tax penalty on corporations that expressly avoid paying dividends to shareholders. The penalty tax is imposed on the portion of retained earnings that exceeds any sensibly predicted corporate expenses or capital investment. The Tax Reform Act of 1986 has eliminated the benefit of accumulating excess earnings in a corporation by eliminating the preferential treatment of capital gains. If income is distributed, a dividend will be taxed at the same rate as the gain on the sale of the corporation's stock. Other taxes may also apply to a corporation that is closely held, such as personal holding tax if the corporation is a personal holding corporation and does not distribute all of its personal holding income.

8.4 Treasury Shares

When a corporation reacquires its own shares (see section 5.1.4), the financial effect on the corporation is basically the same as if the corporation had paid dividends; in both cases the corporation makes a payment and receives nothing of value in return. The shareholders benefit from the acquisition of these treasury shares because their proportional interest in the corporation is increased. The statutory restrictions on the right of a corporation to purchase its own shares differ from state to state, with most states requiring that a corporation's articles of incorporation permit the reacquisition of shares and that such reacquisition be made only by solvent corporations that will continue to be solvent after the transaction.

When a corporation purchases shares of its stock from one of its shareholders, the question arises whether the shareholder should be treated as if he or she received a dividend or had sold the stock (dividends are taxed as ordinary income while the sale of stock is construed as a capital gain or loss). In post-1987 years, the effective tax rates for long-term capital gains and ordinary income will be the same. However, the distinction between the two still must be preserved, because capital losses are only deducted to the extent of capital gains plus $3,000 (IRC Section 1211(b)). Section 302 of the Internal Revenue Code answers this question in these terms: "A redemption of stock by a corporation will be treated as a sale or exchange of the stock if the redemption falls into one of the following four categories:

— "the redemption is substantially disproportionate with respect to the shareholder under IRC Sec. 302(b)(2);
— "the redemption terminates the shareholder's entire interest in the corporation under IRC Sec. 302(b)(3);
— "the redemption is not substantially equivalent to a dividend under IRC Sec. 302(b)(1), or
— "the redemption is of stock held by a noncorporate shareholder and is made in partial liquidation as defined in the Internal Revenue Code of the redeeming corporation. IRC Sec. 302(b)(4), 302(e)"

The Tax Reform Act of 1986 repealed the deduction for 60 percent of net long-term capital gains, which means that all capital gains will be taxed at the same rate as ordinary income. In 1987, however, the maximum long-term capital gain rate was 28 percent.

9. AMENDMENTS, MERGERS, AND DISSOLUTIONS

9.1 Amending the Articles of Incorporation

9.1.1 Right to amend

Most states allow amendments to a corporation's articles of incorporation. The guidelines are set by the MBCA, Section 10.01, which states

> (a) A corporation may amend its articles of incorporation at any time to add or change a provision that is required or permitted in the articles of incorporation or to delete a provision not required in the articles of incorporation. Whether a provision is required or permitted in the articles of incorporation is determined as of the effective date of the amendment.

(b) A shareholder of the corporation does not have a vested property right resulting from any provision in the articles of incorporation, including provisions relating to management, control, capital structure, dividend entitlement, or purpose or duration of the corporation.

9.1.2 Procedure for amending

Generally, if the board of directors of a corporation wishes to amend its articles of incorporation, the directors must adopt a resolution stating the proposed amendment and submit it to a shareholder vote. The directors must give the shareholders notice of the proposed changes along with the date and location of a meeting during which the shareholders can vote on the proposed changes. If the holders of a majority of shares in the corporation vote to accept the proposed changes, the articles of incorporation can then be amended accordingly. The MBCA allows the corporation itself to amend its articles without the unanimous approval of the shareholders.

9.1.3 Filing the amended articles

The customary procedure for filing amended articles is as follows. Duplicate originals of the articles should be filed with the secretary of state. If the secretary of state finds that the amended articles of incorporation conform to the law he will

— Endorse each duplicate original *Filed* and date it.

— File one of such duplicate originals in his office.

— Issue a certificate of amendment to which he shall affix the other duplicate original.

9.2 Mergers

Most state statutes allow for any two or more domestic corporations to merge freely into one of such corporations, with proposed mergers subject to approval by the shareholders of the corporations involved. In addition, the board of directors for each corporation involved in the merger must formulate and state a plan for the exchange of stock that will take place at the time of the merger. There are many complexities in the Internal Revenue Code regarding mergers and liquidations, some of which allow for tax-free treatment on the exchange of assets involved in these types of reorganizations. For detailed analysis of the tax ramifications, practitioners should consult other reference materials, including the various looseleaf services of Commerce Clearing House, Inc., Prentice-Hall, Inc., Bureau of National Affairs, Inc., and Research Institute of America.

9.3 Voluntary Dissolution

Statutory regulations governing voluntary dissolution of a corporation vary greatly from state to state. Generally, state regulations provide for a simple dissolution procedure for business entities that have not yet begun to do business as a corporation. Corporations that have done business as a corporation can usually dissolve by having the holders of a majority of the corporation's stock vote to dissolve the corporation. Directors who wish to dissolve the corporation can adopt a resolution to dissolve but must have this resolution voted on by the shareholders. States normally require that a corporation must have paid all its franchise taxes before the corporation can dissolve. The dissolution of a corporation includes the liquidation of assets and liabilities.

9.4 Involuntary Dissolution

The state, the shareholders, or the creditors of a corporation can take judicial action to dissolve a corporation. Judicial action can be taken to dissolve a corporation when

— The corporation has failed to fulfill a state requirement (for example, failed to file its annual report with the secretary of state).

— The directors of the corporation are deadlocked and the deadlock is doing irreparable damage to the corporation.

— The shareholders of the corporation are deadlocked and cannot elect directors.

— Those in control of the corporation are acting illegally.

— The assets of the corporation are being misused.

— A creditor can show that the corporation is unable to pay its debt.

See the chapter on Bankruptcy/Insolvency, herein.

10. PLANNING HINTS FOR CLOSELY HELD CORPORATIONS

10.1 Who Should Own the Real Estate?

Until passage of the Tax Reform Act of 1986 it was nearly always beneficial to separate real estate from the rest of the business by placing it in a separate S corporation, individual ownership, or a partnership—thereby providing a possible moderate tax shelter for the owner. If the rent received from the real estate is sufficient to cover the real estate taxes and other related expenses, the tax benefit of depreciation deductions will have been shifted from the corporation to an individual. The Tax Reform Act of 1986 placed limitations on losses from passive activities, which the reader must review before doing all planning.

If the real estate owner personally does not have passive income to offset the passive losses generated or cannot effectively use the $25,000 rental realty loss privilege, the real estate could be put into an operating corporation. The passive tax losses of real estate can then be offset by operating income of the corporation, since the limitations on passive losses do not apply to closely held corporations that have active income. However, since a corporation is subject to gain on a sale or distribution of its assets under a plan of complete liquidation, holding real estate in a corporation could be undesirable if it is held for a long period of time. The real estate's tax basis may have been low because of depreciation taken. If the real estate is sold or distributed upon liquidation, the depreciation taken and any appreciation would be subject to a federal tax of up to 34 percent plus state tax. The balance, after deducting the foregoing taxes, would then be subject to regular tax when the shareholders receive the assets of the corporation in the liquidation.

10.2 Giving Nonvoting Stock to Family Members

The owner of a corporation who wishes to transfer some of the wealth of the corporation to family members should consider setting up two classes of stock, voting and nonvoting, when the corporation is set up, which will allow allocation of the wealth among family members by the transfer of nonvoting shares to family members. Since the transferred shares have no voting rights, the family members receiving them normally will have no say in the management of the corporation. (Some states allow holders of nonvoting shares to vote on certain major issues, but this is rare.)

10.3 Avoiding Special Penalty Taxes

Corporations usually avoid paying accumulated earnings tax by paying dividends to shareholders. If shares of stock have been issued to family members, it will be desirable to pay dividends only to children over age fourteen who are in a low tax bracket. This can be accomplished by creating a preferred series of stock that gives certain shareholders special rights to dividends. The owner of the corporation would then distribute the preferred shares only to those children he or she wishes to receive the dividends.

10.4 Choosing a Fiscal Year

New corporations other than certain S corporations or personal service corporations (see section 1.4 herein) can choose a taxable year ending in any month. For tax purposes, a corporation should adopt a fiscal year that ends just before the corporation's busy season begins. In this way, the corporation will not pay the tax on the income it earns during its busy season until the following fiscal year. There are benefits for the officers and employees of a closely held corporation that chooses an early-calendar-year month as its fiscal year end. In this way any fiscal year end bonuses or dividends will be paid to the individuals in the beginning of their taxable year when they can still plan to minimize their taxes for the calendar year.

For financial statement purposes, a fiscal year should end with the close of a cycle of business activity. Theoretically, this would be when inventories and accounts receivable are at a minimum and before new inventory is acquired for another cycle of sales.

10.5 Tax Interview Checklist

Because of the complexity of corporate income tax laws and regulations, it is recommended that an annual checklist approach be used when completing the corporate income tax returns. This approach will help ensure that no significant items are overlooked when completing the return. The Appendix to this section includes a sample interview checklist that can be adapted and expanded upon.

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APPENDIX 1: Incorporation Checklist

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
1. Target Date (date corporation is to commence business).	____	____	____	____	____
2. Incorporators (names and addresses).	____	____	____	____	____
3. Directors and Officers (names and addresses).	____	____	____	____	____
4. Statutory Agent (name and address).	____	____	____	____	____
5. Drafting Articles of Incorporation.	____	____	____	____	____
6. Meeting of Incorporators (elect officers, transfer assets for stock, adoption of bylaws, adoption of seal, designation of depository, etc.).	____	____	____	____	____
7. Assets and Liabilities (determine what assets and liabilities are to be turned over to the corporation and shares issued in exchange therefor).	____	____	____	____	____
8. Identification Number (Form SS-4).	____	____	____	____	____
9. Workmen's Compensation (file for coverage).	____	____	____	____	____
10. Unemployment Compensation (file for coverage).	____	____	____	____	____
11. Transfer of Credit from Unemployment Compensation (if incorporating existing business).	____	____	____	____	____
12. Federal Unemployment (determine if final Form 940 is to be filed on old business).	____	____	____	____	____
13. Final Returns (if incorporating existing business).	____	____	____	____	____
14. Thin Corporation (debt structure and ratio of debts to equity in view of current and future financing requirements).	____	____	____	____	____

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
15. Election under Subchapter S (if going to elect, prepare and file Form 2553).	______	____	____	______	______
16. IRC §1244 (should issue stock in accordance with §1244 and adopt "plan" before shares are issued).	______	____	____	______	______
17. Multiple Corporations (determine if a problem).	______	____	____	______	______
18. Accounting Methods (year-end accrual or cash basis, bad debt election, depreciation method, inventory valuation).	______	____	____	______	______
19. Books and Records (chart of accounts, ledger and journals).	______	____	____	______	______
20. Officers' Salaries (establish officers' salaries and fill out Form W-4 authorizing corporation to withhold wages)	______	____	____	______	______
21. Banks (select bank or banks and furnish resolution authorizing persons to sign checks and negotiate loans).	______	____	____	______	______
22. Notify Utilities.	______	____	____	______	______
23. Insurance (notify all pertinent insurance agents so that insurance policies may be transferred to the corporation if incorporating existing business; if new business, secure necessary insurance, i.e., fire, liability, etc.).	______	____	____	______	______
24. Special Licenses and Permits (secure, if necessary).	______	____	____	______	______
25. Accident and Health (formally adopt a plan under §105(c) and §106, if desired).	______	____	____	______	______
26. Wage Continuation (formally adopt a plan under §105(d)).	______	____	____	______	______
27. Medical Reimbursement Plan (formally adopt a §105(b) medical reimbursement plan, if desired).	______	____	____	______	______

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
28. Death Benefit (formally adopt the special $5,000 death benefit under §101(b), if desired).					
29. Group Term Life (consider desirability of instituting).					
30. Pension and Profit Sharing Plan.					
31. Car Requirements (if employee is to furnish car, formally require him to do so in written agreement).					
32. Employment Agreement (prepare an employment agreement for each shareholder).					
33. Redemption or Buy/Sell Agreements.					
34. Lease:					
a) personal property					
b) real estate					
35. Corporate Records (stock certificates, stock register, minutes, corporate seal).					
36. Stock Issue (issue shares of stock bearing necessary signatures and with corporate seal affixed; complete stock register; obtain receipts or have stubs initialed).					

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APPENDIX 2: Tax Interview Checklist

Form 1120 Interview Worksheet   Client: ______________________

DONE BY: Interviewer______; Preparer____________; Reviewer____________
(initials & date)   (initials & date)   (initials & date)

A. For Interviewer	Done	N/A	Comments or Explanations
1. Do we have engagement letter in file?			
2. Thoroughly compare prior year return to current data, scan prior file notes, prior year points, correspondence			
3. Any notices/correspondence from IRS or state?			
4. Any corp.-owned life insurance to Sch. M-1?			
5. Farm Corps.: a. Have data on CCC loan method & PIK certs.?			
b. Discuss 1988 FICA change: No \$150 exception if all payroll (incl. in-kind) is over \$2,500			
c. Does \$750 refundable ITC apply (Limit: Lesser of (1) 15 yr. prior tax; (2) 50% of carryover; (3) \$750; but before 35% reduction) — tax yr. beginning in 1987			
d. Any 50% prepaid expense limit?			
e. Dairy, beef, etc.: 1) 2 yr. preprod. rules apply?			
2) Elect out & use slower depr.?			
6. Were all W-2's & 1099's done? Who's to do?			
7. Claim Section 179? Fast or slow depreciation?			
8. Identify amount of 20% disallowed meals/enter.			
9. Any changes for next year's quarterly estimates?			
10. Complete worksheet at end re. vehicles & mileage			
11. Manufacturers to whom uniform capitalization rules apply: a. Identify Sec. 263A current year costs			
b. Revalue beginning inventory & 4 yr. spread			
12. Contractor using completed-contract method? ('86 & '87 Act rules)			

	Done	N/A	Comments or Explanations
13. Bad debts — Reserve Method: Bring ¼ back into income.			
14. Corp. AMT: What is "book income" for 50% preference?			
15. Any data back to client to be copied for our file?			
16. Any discussion with client re: expected outcome?			
B. For Preparer 1. Review file thoroughly for any prior notes/carryovers into this TR			
2. After reaching net income amount, consider any adjustments up or down or other elective items to improve results			
3. Corp. AMT: Prepare a worksheet to test AMT, especially re: 50% book preference			
C. For Reviewer 1. Are all interviewer and preparer points cleared?			
2. Any follow-ups re: add. work/ carrybacks?			
3. Any carryforward points for next year?			
4. Any T/letter advice points for client?			

4562 **Section B.—Information Regarding Use of Vehicles**

Complete this section as follows, if you deduct expenses for vehicles

- *Always complete this section for vehicles used by a sole proprietor, partner, or other more than 5% owner or related person*
- *If you provided vehicles to employees, first answer the questions in Section C to see if you meet an exception to completing this section for those items*

	Vehicle 1		Vehicle 2		Vehicle 3		Vehicle 4		Vehicle 5		Vehicle 6	
1 Total miles driven during the year												
2 Total business miles driven during the year												
3 Total commuting miles driven during the year												
4 Total other personal (noncommuting) miles driven												
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
5 Was the vehicle available for personal use during off-duty hours?												
6 Was the vehicle used primarily by a more than 5% owner or related person?												
7 Is another vehicle available for personal use?												

Section C.—Questions for Employers Who Provide Vehicles for Use by Employees.

(Answer these questions to determine if you meet an exception to completing Section B **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons)*

	Yes	No
8 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
9 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
10 Do you treat all use of vehicles by employees as personal use?		
11 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
12 Do you meet the requirements concerning fleet vehicles or qualified automobile demonstration use (see instructions)?		

Note: *If your answer to 8, 9, 10, 11, or 12 is "Yes," you need not complete Section B for the covered vehicles*

S CORPORATIONS

S CORPORATIONS

1. HISTORY

1.1 History of the S Corporation

In 1958 Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code of 1954, as amended, was enacted. Under this law, corporations with Subchapter S status (then called Subchapter S corporations) were not treated like partnerships for determining shareholder income and losses, but were treated as passthrough entities with certain restrictions. In order to receive and maintain Subchapter S status, corporations had to accept certain restrictions, such as a maximum number of shareholders and limitations on the classes of stock issued.

Despite the restrictions imposed by the status and notwithstanding the regulations and rulings added since 1958, increasing numbers of corporations chose to adopt Subchapter S status as time went by. As the popularity of Subchapter S continued to rise, and even further regulations governing it were added to an already complex set, the need to simplify all matters relating to Subchapter S and its regulation became increasingly clear. Eventually Congress revised Subchapter S. The 1982 Subchapter S Revision Act was the product of a collegial group (including the American Institute of Certified Public Accountants (AICPA)) similar to the one formed to prepare the 1980 Installment Sale Revision Act. This group's work was embodied in the April 30, 1980, joint committee pamphlet, which would have provided an even simpler system than that contained in the 1982 act.

1.2 The Subchapter S Revision Act of 1982

The Subchapter S Revision Act of 1982 (SSRA) made major revisions and changes in Subchapter S. For the purposes of this chapter, discussion of these changes and additions have been incorporated into the sections to which they apply. The following is a list of the provisions effected by the SSRA:

- Increased eligible shareholders
- Permitted more than one kind of common stock (Voting rights of the common stock need not be the same, but, in all other respects, the stock must be identical.)
- Expanded the definition of eligible corporations
- Eased passive income restrictions
- Made passthrough of income and losses similar to that permitted under partnership rules

— Promulgated new basis-of-stock rules

— Imposed a new set of rules for taxable year ends

— Limited fringe benefits

The SSRA also officially designated the name *S corporation* for corporations that have qualified under Subchapter S and designated all other corporations *C corporations.*

1.3 Advantages of Operating as an S Corporation

One of the most attractive features of an S corporation is the fact that its shareholders limit their personal liability to trade creditors while avoiding double taxation—taxation at both the corporate and the shareholder level. Bank lenders and landlords typically require shareholder guarantees of corporate borrowings or leases, at least in the early stages of the business enterprise. The guarantee removes insulation of personal liability to the extent of the loan or lease. However, shareholders would still, in most instances, be shielded from personal liability for acts arising in the ordinary course of the corporation's business. In addition, losses experienced during the first few years of a developing corporation's existence can be passed through to the shareholders, who may be able to use the losses to offset other income. While general partnerships and proprietorships offer these same advantages, they cannot offer the limited liability of the S corporation.

An S corporation has these advantages over a C corporation:

— Avoids the accumulated earnings tax under Section 531.

— Avoids the unreasonable compensation problems that occur when officers' salaries are high enough to run the risk of being reclassified as dividends.

— In certain cases, S corporation status will avoid corporate tax on sale or distribution of appreciated assets in a complete liquidation (see section 7.2).

— May afford an overall tax saving, since the maximum corporate rates (34 percent) are higher than individual rates (28 percent).

— Avoids onerous alternative minimum tax (AMT) for regular corporations under the Tax Reform Act of 1986 (which requires a minimum tax on taxable income), increased by preference items and other adjustments. Alternative minimum income includes 50 percent of the excess of book income over taxable income (the book income preference item potentially subjects to tax all municipal bond interest, intercorporate dividends (before 70 percent deduction or 80 percent deduction if the corporate shareholder owns 20 percent or more of the stock of the dividend-paying corporation), and life insurance proceeds). The book/tax preference is one of the most controversial aspects of the corporate AMT. Financial statement income (if greater than taxable income) can increase substantially a corporation's federal tax liability.

A corporation may find S corporation status beneficial if it is anticipating substantial losses. If the losses are ordinary losses, the tax savings for shareholders may outweigh the tax savings the corporation could receive as carrybacks or carryforwards. In this case it is usually in the best interest of the shareholders to elect S corporation status. Personal holding companies can also benefit from S corporation status, which permits the company to eliminate personal holding company tax. However, there is a 25 percent passive receipts limitation for S corporations that have retained earnings and have converted from C corporation status to S corporation status (see section 6.1).

Historically, S status has been elected to permit deduction of operating losses at the shareholder's level. Under the Tax Reform Act of 1986, unless the shareholder is active in the business (active in a material, significant, and consistent manner), S losses are treated as passive activity losses to inactive shareholders and are deductible only against the shareholders' passive activity income. Thus, S corporation losses of inactive shareholders cannot be deducted against salary, dividends and interest, and so forth.

If an inactive shareholder was a shareholder before October 22, 1986, the deduction for these losses will be disallowed as follows:

1987	35%
1988	60%
1989	80%
1990	90%
Thereafter, 100%	

Unused losses from passive activities are carried forward indefinitely and are used to offset passive income in succeeding years.

S corporations allow a taxpayer who is the sole shareholder of an S corporation to pass along business profits to family members other than spouses (discussed later in this chapter) and save money at the same time. The shareholder can give away shares to family members (up to the maximum shareholder limit) and divide the profits of the S corporation among them based on their percentage of ownership. This limits the amount of profit on which the original taxpayer has to pay tax but keeps the money in the hands of family members who may very well fall into a lower tax bracket than the taxpayer. By naming children over the age of thirteen as shareholders it is possible to have the additional profit taxed at the minimum rate. Such a plan does, however, have a major limitation: The taxpayer must claim a percentage of the profits as salary large enough to compensate for the amount of work he or she does for the corporation and the amount of capital he or she has provided to the corporation. If the IRS feels that the taxpayer is not claiming a sufficient percentage of the corporation's taxable income, it may increase the original taxpayer's percentage and lower the percentages of the other family members. In addition, the IRS may claim the transfer of stock to the children is a "paper transaction" if the transfer did not include all rights and privileges of stock ownership. In such a case, the IRS may tax the entire income as income earned by the donor parent.

1.4 Disadvantages of Operating as an S Corporation

Despite its many advantages, there are situations in which S corporation status is not advantageous. For corporations that reinvest earnings, the shareholders would be taxed on the profits without receiving cash from the corporation to pay the tax. As a general rule, the higher the corporation's taxable income the more likely is S corporation status to be beneficial even if part of the earnings are retained. This results from the fact that tax on corporate income over $75,000 is higher than on individual income (34 percent on corporate income, 28 percent on individual income). However, the first $50,000 of corporate earnings will be taxed at only 15 percent starting in 1988, which will be lower than the 28 percent marginal rate for individuals at that time. Other disadvantages of operating as an S corporation include

— Loss of income splitting between a C corporation and its shareholders.

— No special allocation provisions for income and deductions, as in the case of a partnership.

— No preferred stock freeze in a recapitalization. (See the chapter on Estate Planning, herein, section 5.1.2.)

— No employee stock-ownership plan (ESOP). Under an ESOP, the plan invests primarily in employer stock. The S corporation rules prohibit ownership of the stock by a trust other than a qualified trust. (See section 2.2.2 of this chapter.)

— S corporations, like partnerships and individuals, are subject to "passive-activities" provisions that eliminate the sheltering of salaries, interest, and dividends with losses from tax shelters. C corporations (other than personal service corporations) can offset passive tax losses against operating income of the corporation but not investment income.

— Nine states and the District of Columbia do not recognize S corporations, which in those jurisdictions pay state taxes at corporate rates.

— No 80 percent dividend-received deduction for S corporations.

— Certain employee tax-advantaged benefits for shareholders owning more than 2 percent of S corporation stock deductible by C corporations are not excludable by S corporation shareholders. (See section 8.4 below.)

— Operating problems from insurgent shareholders who might take actions to disqualify the S corporation status.

— Passive income tax if the corporation's investment income exceeds 25 percent of its gross income (applicable to complex S corporations with Subchapter C accumulated earnings and profits at end of year). (See section 6 of this chapter.)

— Five percent or larger shareholder participants cannot borrow from employee retirement plan trusts. (See the chapter on Employee Retirement and Deferred Compensation Plans, section 3.11, herein.)

2. ELIGIBILITY REQUIREMENTS

If a corporation wishes to be treated as an S corporation, it must file an election (Form 2553) within a specified period of time. Certain other requirements, discussed in this section, must be met by the date of the election.

2.1 Corporation Requirements

2.1.1 Domestic corporations

To be eligible for an S corporation election, a corporation must have legal existence and must have been created and organized in the United States. The corporation must be operated with a profit intent, not just as a hobby. (Hobby-loss curbs in Section 280A are equally applicable to a C corporation, partnership, or individual; that is, they are not unique to an S corporation.)

2.1.2 Ineligible corporations

The SSRA defined certain corporations as ineligible for S corporation status, including:

— Insurance companies subject to tax under Subchapter L.

— A domestic international sales corporation (DISC) or former DISC. An S corporation may not hold a foreign subsidiary or a DISC unless the S corporation held the foreign subsidiary or DISC on September 28, 1982. In that case, the corporation can remain an S corporation as long as its election does not terminate and a majority of its stock is not transferred other than by reason of death (SSRA Sec. 6 (c) (1)).

— A member of an affiliated group (where *affiliated group* is defined as the case in which a parent corporation owns 80 percent or more of a subsidiary's voting power and stock value and 80 percent or more of the value of each class of its nonvoting stock with the exception of limited and preferred nonvoting stock). There is an exception for inactive subsidiaries.

— A financial institution that is allowed a deduction for bad debts under Section 585 or Section 593 (bank or thrift institution).

— A corporation electing the Puerto Rico or possessions tax credit (Section 936).

2.2 Stock and Shareholders

2.2.1 Maximum number of shareholders

To be treated as an S corporation a corporation may have no more than thirty-five shareholders. When counting shareholders it is important to consider the following factors:

— Husbands and wives who own stock are counted as single shareholders regardless of whether the stock is owned jointly or not, and consent of both spouses is required. If the marriage is dissolved and both former spouses retain stock in the corporation, they are counted as separate shareholders.

— Estates are counted as single shareholders so long as the stock remains part of the estate. Once the stock is distributed to the beneficiaries, each beneficiary receiving stock is counted as a shareholder.

— Persons who are not husband and wife and who own stock jointly are counted as separate shareholders.

When a trust qualifies as a shareholder (see section 2.2.2, below) the following rules apply:

— Each beneficiary of a voting trust is counted as a shareholder.

— The grantor or owner of a grantor or Section 678 trust is counted as the shareholder.

— The estate of the testator is counted as the shareholder of a qualifying testamentary trust.

— The one beneficiary of a qualified Subchapter S trust is counted as the shareholder.

2.2.2 Eligible shareholders

Qualified shareholders of stock in an S corporation are limited to

— Individuals (except nonresident aliens).

— The estate of a decedent.

— The estate of a bankrupt individual.

— A specified trust (defined below).

Trusts that qualify as shareholders of S corporations include

— A voting trust where each beneficiary is treated as a separate shareholder (Sec. 1361(c)(2)(B)(iv)).

— A trust owned entirely by a grantor who is a U.S. citizen or resident and that is an eligible shareholder for two years after the grantor's death (Sec. 1361(c)(2)(A)(ii)).

— A trust that has Subchapter S stock transferred to it as part of a will, restricted to a sixty-day period that starts on the day of the transfer (Sec. 1361(c)(12)(A)(iii)). The period is increased to two years if the trust's entire corpus was included in the gross estate.

— A subpart E grantor trust (Sec. 1361(c)(2)(A)(i)).

— A trust of which someone other than the grantor is treated as the owner of the entire trust under Section 678.

— A qualified Subchapter S trust (Sec. 1361(d)(3)) (defined below).

A qualified Subchapter S trust (QSST) is a trust that owns stock in at least one S corporation and distributes (or is required to distribute) all its income currently to an individual who is the sole income beneficiary of the trust. Note that Section 1361 (e) (3), relating to qualified Subchapter S trusts, recently amended, treats separate shares of a multiple beneficiary trust under Section 663 (c) as separate trusts for qualifications as QSST. This provision has been made retroactive to the effective date of the 1982 Subchapter S revision. A partnership or a corporation cannot be a qualified trust. In addition, a qualified Subchapter S trust must

— Permit only one income beneficiary (who is a U.S. citizen or resident) at a time.

— Distribute corpus only to the income beneficiary.

— Provide that the income interest of the current income beneficiary must terminate in the event of either the termination of the trust or the death of the income beneficiary.

— Provide that all corpus will be distributed to the income beneficiary if the trust is terminated during the life of the income beneficiary.

2.2.3 Classes of stock

S corporations may have only one class of stock, with only outstanding shares counted. Outstanding shares must entitle all shareholders to identical rights concerning the dividends and liquidating distributions of the corporation. Regulation Section 1.1371-1(g) specifies that a corporation authorized to issue different classes of stock may not be barred from making a valid S election if only one class of stock is issued and outstanding. In other words, the existence of other classes of stock either authorized or unissued does not bar an S election. S corporations can, however, issue voting stock to shareholders with managing interests and nonvoting stock with identical rights as to dividends and liquidating distributions to shareholders who own stock for investment purposes. The nonvoting stock will not be classified as a second class of stock (Section 1362 (d) (4)). Unexercised warrants, options, and convertible debentures issued by the corporation do not constitute a second class of stock. Certain debt may be determined to actually represent capital, and if deemed to be capital, could be considered a second class of stock.

Section 1362 (b) (5) provides a "safe harbor" wherein straight debt in an S corporation will not be treated as a second class of stock. Straight debt is a written unconditional promise to pay on demand or on a specific date a certain sum in money if

— The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors.

— There is no direct or indirect convertibility to stock.

— The creditor is a person, estate, or trust eligible to hold S corporation stock.

3. MAKING AN S CORPORATION ELECTION

3.1 Timely Filing of Form 2553

Once a corporation meets all the eligibility requirements for becoming an S corporation, it must still make a valid election before being treated as an S corporation, on or before the fifteenth day of the third month of the taxable year (March 15 for calendar-year corporations) or in the preceding year. If the election is made after this date, the corporation will not be treated as an S corporation until the beginning of the next tax year.

An S corporation election is made by filing Form 2553. Form 2553 or a separate written consent must be signed by all of the stockholders (see section 3.2, below) and Form 2553 signed by a corporate officer who is authorized to sign the corporation's tax return and is usually filed at the IRS service center where the corporation will file its tax returns. No extensions may be granted for filing the election on Form 2553. However, extensions may be granted for filing the shareholders' consents (see section 3.2, below).

3.2 Shareholder's Consents

All shareholders in a corporation making an election must consent in writing to the election. If the election is to be effective in the year in which it is made, any person who was a shareholder at any time during the year in question must consent to the election regardless of whether or not he or she is a shareholder at the time of the election. Consent may be made on Form 2553 or in a separate statement.

Any persons who become shareholders after the election has been filed are bound by the election unless it is revoked or terminated. Only majority shareholders (those owning more than 50 percent of the corporation's stock) may revoke the election. Any shareholder can cause the election to be terminated by transferring shares to a disqualified shareholder.

It is possible to get a time extension when the election has been filed within the specified time limit but a shareholder has failed to consent in time. To receive such an extension the corporation must satisfy the IRS that there was reasonable cause for the failure to file the consent on time and must show that the interest of the government will not be jeopardized by allowing the election. Once the IRS has granted the extension, any shareholders who have not consented must do so within the extension period. In addition, new consents must be filed by any persons who were shareholders at any time during the year in which a shareholder failed to file a consent. Any additional persons who have become shareholders before the end of the consent period must also file consents. Remember that all consents must be filed within the extension period.

3.3 Election by a Beneficiary of a Qualified Subchapter S Trust (QSST)

The S corporation election is made by the income beneficiary who is the deemed owner and must be made separately with respect to each S corporation stock that is held by the trust. The beneficiary must elect within two months and fifteen days beginning on the later of the following two dates:

— The date the stock is transferred to the trust.

— The first of the taxable year on which the corporation's S election is effective.

The election by a beneficiary of a QSST is an election to be made in addition to the election made on Form 2553 and the consents to that form.

3.4 Taxable Years

The 1986 Tax Reform Act required that, beginning in 1988, most S corporations use as fiscal years calendar years (ending on December 31) regardless of when the corporation elected to be taxed as an S corporation. For example, an S corporation with a fiscal year ending September 30, 1986, would be required to file a tax return for the year ending September 30, 1987, and a short return for the period beginning October 1, 1987, and ending December 31, 1987. An S corporation that wants to use any other accounting period must establish a business purpose to the satisfaction of the secretary of the Treasury or comply with a portion of Revenue Procedure 83-25, 1983-1 C. B. 689. Portions of Revenue Procedure 83-25 that granted automatic approval for a permitted year for existing S corporations seeking a change in taxable year, which permitted a three-month deferral in income between the entity and its principal owners, has been repealed by the Tax Reform Act of 1986, effective December 31, 1987. With regard to approval for a permitted year, Revenue Procedure 83-25, which grants automatic approval for a permitted year to a corporation filing an S election based on the taxable year of shareholders owning a majority of the stock, still applies. Under remaining portions of Revenue Procedure 83-25, an S corporation may retain or adopt a fiscal year that satisfies the 25 percent Safe-harbor test as a natural year end for the business purpose test (that is, 25 percent of gross receipts on a three-year average occur in the last two months of the desired fiscal-year end). Fiscal year S corporations that had not received approval for a permitted year under Revenue Procedure 83-25 must either convert to a calendar year or obtain consent from the IRS to continue to use a fiscal year (Revenue Procedure 87-32 and Revenue Ruling 87-57, IRB 1987-28).

The Revenue Act of 1987 contains a special provision for fiscal year end S corporations under which an S corporation could elect to retain its current fiscal year, even though it would be required by the 1986

Tax Reform Act to change to a calendar year. The 1987 act also provides an election whereby an S corporation can adopt or change to a new fiscal year in which the deferral period would be three or fewer months.

The election is made by filing Form 8716 on or before April 30, 1988, or sixty days after the publication of temporary regulations in the *Federal Register,* whichever is the later date. The first required payment would be due no earlier than the election date. Electing S corporations must file the Form 720 Quarterly Federal Excise Tax Return and make tax payments if required (IRS Notice 88-10, IRB 88-5).

There is a price to be paid for this election. S corporations must make a "required payment," thus taking away the advantage of a tax deferral. In general, S corporations would be paying approximately the same amount in "required payments" as their owners would have paid in actual tax payments for the short period had the entity changed to the calendar tax year.

The required payments are not deductible by the S corporation (or by any other person) for federal income tax purposes. Rather, these required payments are in the nature of refundable deposits, which do not earn interest. Furthermore, the payments are not passed through to S shareholders.

Those S corporations allowed a fiscal year based on the established business purpose test (including the 25%-percent-of-revenue test reflected in Revenue Procedure 87-32 and Revenue Ruling 87-57) are not affected by the Revenue Act of 1987. They need not file an election nor make required payments.

Effective for years beginning after December 31, 1986, if the S corporation (only if the corporation was an S corporation for the taxable year beginning in 1986) changes to a calendar year end and there is a

(Text continued on page 125)

short-year bunching of income in the year of change, the short-year income is spread over four years unless the shareholder elects to include it all in 1987. Each shareholder decides individually.

4. TERMINATING AND REVOKING AN ELECTION

4.1 Termination

A corporation retains S corporation status until the election is terminated or revoked. Termination occurs when any of the eligibility requirements for electing an S corporation is violated (for example, the corporation has more than thirty-five shareholders or issues a second class of stock or a shareholder in a community property state marries a nonresident alien). Elections can be terminated for certain S corporations if the corporation has excessive passive investment income (see section 6 of this chapter). If a terminating event occurs, the corporation loses its S corporation status as of the day of the event: the termination is not retroactive to the beginning of the year.

A corporation should report a terminating event to the IRS, including the cause and the date. If a transfer of stock to a nonqualified shareholder is the termination cause, the corporation should also include the number of shares transferred, name of the recipient, and the names of the original shareholders. If a second class of stock was issued, the number of shares of new stock should be reported along with a description of the features of the new stock that make it different from existing stock still outstanding. See section 5.2 below for circumstances under which the IRS can waive inadvertent termination of S election.

4.2 Revocation

An election can be revoked by persons holding more than 50 percent of the corporation's outstanding stock. In contrast to a termination, a revocation can be retroactive to the beginning of the taxable year if it is made on or before the fifteenth day of the third month of the taxable year. If the revocation is made after this day, the corporation can specify whether it wishes the revocation to take place immediately, at the beginning of the next taxable year, or at any date in between. A corporation can specify a date for the revocation only if the date chosen is on or after that of the revocation. To make a revocation, a corporation must file a written statement with the IRS service center where the election was filed.

4.3 Reporting Following a Termination or Revocation

If a corporation's status changes from that of an S corporation to that of a C corporation at any time during a taxable year, the corporation must file two tax returns: one for the portion of the year when the corporation was an S corporation (S short year) and one for the remainder of the year (C short year). The returns for the two short years are both due on the date specified for the return of the C short year. The corporation can allocate income or loss either by a pro-rata daily method or by electing the normal tax accounting method (interim closing of the books). (See Sec. 1362 (e) (2) and (3).) If more than 50 percent of the shares of the corporation were sold or exchanged during the year, normal tax accounting rules must be used (Sec. 1362 (e) (6)).

4.4 Re-Electing (The Five-Year Waiting Period)

In general, after termination of an election a corporation must wait a full five years before making another election. The five-year waiting period applies regardless of whether termination was voluntary or involuntary. The IRS has the power to consent to an earlier election (Sec. 1362 (g)). For terminations before October 22, 1986, the Internal Revenue Service has declared a general amnesty, and re-elections without the five-year waiting period are permissible.

5. PREVENTING UNWANTED TERMINATION OF ELECTIONS

Termination of an election, whether intentional or inadvertent, causes a corporation to be reclassified as a C corporation. Shareholders who wish the corporation to remain an S corporation should take steps to ensure that the election is not terminated because of careless lack of compliance.

5.1 Invalid Elections

If an election is invalid from the onset, no corrective action can be taken afterward to correct the situation, and the corporation will not be exempt from income taxation at the corporate level. If the election is not effective because it was filed after the fifteenth day of the third month of the taxable year, it will become effective at the beginning of the next taxable year. In this case the corporation will only be responsible for paying corporate income tax plus interest for the period of time before the election became effective (additional penalties may also be levied for failure to pay estimated tax). If, however, the election is invalid because the election process was invalid, no election ever occurred and the corporation is responsible for all corporate taxes and interest accumulated plus any penalties incurred. If it is discovered that no election was ever made, the corporation can make a new election immediately, since in such a case the five-year waiting period does not apply. To prevent any of these situations from arising, the shareholders should verify that the election was indeed valid before treating the corporation as an S corporation. Even though the IRS service centers send S-election acceptance letters to filing corporations, proof of mailing the election by certified mail and a receipt should be requested, because the IRS or the U.S. Postal System could lose Form 2553 and no acceptance letter would be received.

5.2 Inadvertent Termination of Elections

Any action that causes a violation of the eligibility requirements of an S corporation will cause the corporation's election to be terminated despite the fact that the action may be inadvertent or carried out by certain shareholders without the knowledge and consent of other shareholders (for example, if a shareholder sells his or her shares to an ineligible shareholder). If the termination is inadvertent, a corporation may receive permission from the IRS under Section 1362 (f) to treat it as though it had never occurred: the corporation will be treated as an S corporation during the period of termination if the IRS agrees that the termination was inadvertent and steps are taken to remedy the situation within a reasonable amount of time. In the case presented in Letter Ruling 8620027, an S corporation issued stock to two nonresident aliens. All persons involved in issuance of shares to nonresident aliens were unaware that this would terminate the election. One month after the corporation's accountant discovered the shares had been issued, a portion of the shares were sold to U.S. residents and the corporation redeemed the balance. The service ruled that the transfer of shares to the nonresident aliens constituted an inadvertent termination within Section 1362(f) and the corporation was treated as continuing to be an S corporation during the period of termination, with the nonresident aliens treated as S shareholders during this period.

5.3 Methods of Protecting the Election

5.3.1 Transfer of stock to escrow

If shareholders agree to transfer possession of their shares to an escrow agent, no shareholder can transfer stock without first consulting the agent. The agent, who can be one of the shareholders, could then discuss any proposed transfers of stock with all the shareholders before allowing them.

5.3.2 Shareholders' agreements

If all shareholders consent, an agreement to protect the election can be created. An agreement to protect an election should include

— A statement of intention to continue the election.

— A restriction on transfers of shares.

— An option-of-first-refusal by either the shareholders who are not transferring stock, or by the corporation redeeming the stock.

— A predetermined buyout price.

— A provision to prevent a majority of shareholders from revoking the election.

6. PASSIVE INCOME PROBLEMS

Passive income, also called passive investment income, generally includes gross receipts from investment items. Rents (except where substantial services are performed), royalties, dividends, interest (including tax-exempt interest but excluding interest from notes resulting from the sale of inventory), annuities, and gains from sales and exchanges of stocks and securities are usually classified as passive income and prior to 1982 presented problems to many S corporations. Since the SSRA, however, passive income no longer presents a problem for the vast majority of S corporations. For new S corporations, no passive income restrictions apply (for example, new S corporations have no restrictions on income earned from rental property). This is also the case for S corporations with no C corporation accumulated earnings and profits at the end of the taxable year. Problems arise for corporations with C corporation earnings and profits when passive income constitutes more than 25 percent of the corporation's gross receipts (see section 6.1. below). In this situation, passive income in excess of the allowable limit will be taxed at the highest corporate rate. In addition, excessive passive income can lead to termination of an election when

— The corporation has C corporation earnings and profits at the end of three consecutive tax years.

— Passive investment income accounts for more than 25 percent of the corporation's gross receipts in each of those three years.

It is therefore necessary for S corporations with C corporation earnings and profits to prevent passive income from exceeding the allowable level.

6.1 Gross Receipts

To determine if passive income presents a problem for an S corporation one must understand the IRS's definition of gross receipts. The IRS defines gross receipts as the total amount of receipts not reduced by returns, allowances, costs, or deductions. For sales and exchanges of capital assets other than stocks and securities (stock trading gains are passive receipts), however, only the gains from such transactions are counted when figuring gross receipts. In addition, loans, repayments of loans, contributions to capital, and issuance by a corporation of its own stock do not count as gross receipts.

6.2 Preventing Passive Income Problems

6.2.1 Incorporating rental property in a subsidiary

If rental income creates passive income problems for a corporation, the corporation can choose to incorporate the rental property in a subsidiary—thus eliminating the passive income from the parent corporation. The corporation may not, however, own 80 percent or more of the subsidiary. The parent corporation can own 79 percent of the subsidiary stock, and shareholders can hold the other 21 percent directly.

6.2.2 Increasing gross receipts

A corporation that is in danger of having passive income exceeding the 25 percent gross receipts limit can protect itself by increasing its gross receipts from nonpassive-income sources. One method is to sell capital assets other than stocks and securities for a capital gain. The capital gain on the sale or exchange will increase the corporation's gross receipts but, because the gain was not on the sale or exchange of stocks or securities, it will not be counted as passive income.

6.2.3 Additional methods

Additional methods for preventing passive income problems include paying out the C corporation's accumulated earnings and profits. Remember, however, that the S corporation shareholders will be taxed on the distribution as a dividend. Earnings and profits consist of all recognized income (both taxable and nontaxable) reduced by all losses and payments (both deductible and nondeductible).[1]

7. TAXATION AT THE CORPORATE LEVEL

In the great majority of instances S corporations are not subject to corporate income taxes. S corporations that were C corporations prior to election are, however, subject to investment credit recapture on assets acquired when they were C corporations. In addition, certain long-term capital gains are also subject to corporate tax. Capital gains tax exists to prevent elections prior to sale for the purpose of avoiding corporate-level tax on a gain.

7.1 General Utilities Repeal

The Tax Reform Act of 1986 repealed the "general utilities" doctrine (General Utilities & Operating Co. 296 US 200 (1935)). Before the Tax Reform Act of 1986, a C corporation could sell virtually all of its assets for cash, distribute the cash and balance of its assets to its shareholders, and avoid corporate-level tax except for investment credit and depreciation recapture by liquidating within a twelve-month period after adopting a plan of liquidation (IRC Section 337). The shareholder would pay a tax on the distribution of the proceeds.

The shareholder tax on distribution of the proceeds is not an outcome of the Tax Reform Act of 1986, but a continuation of the law as it existed prior to the repeal of the "general utilities" doctrine. Note that there is a corporate tax on liquidation, even if there is no sale of assets.

Now, if a C corporation sells its assets and liquidates, it will pay a corporate level tax on the gain, with its shareholders being subject to

[1] Irving Schreiber and Sydney S Traum, *The S Corporation. Planning and Operation* (New York: Panel Publishers, 1987), p 8.3

tax on the distribution of the proceeds. This double tax will not apply to the sale of assets of certain S corporations (see sections 7.2 and 7.3, below).

7.2 Tax on Capital Gain Under Old Section 1374

For S corporation elections made on or before December 31, 1986, an S corporation may be taxed on certain capital gains under the old Section 1374. (See section 7.3 below for transition rules for elections made before 1989.) If a corporation has been an S corporation for the three years preceding the taxable year in question, the corporation is not subject to tax on capital gains. A corporation that has been an S corporation for its entire existence is also not subject to tax on capital gain. If neither situation applies, a corporation's long-term capital gain is subject to corporate tax if all of the following three situations exist (Sec. 1374):

— Excess of long-term capital gain over short-term capital loss exceeds $25,000.

— Capital gain accounts for more than half of the corporation's taxable income.

— The corporation's taxable income exceeds $25,000.

A corporation will also be subject to corporate tax if the corporation acquired property during the taxable year and the preceding three years and

— The basis of the property is determined in whole or in part by reference to the basis of any property in the hands of another corporation.

— The other corporation was not an S corporation throughout the prior three years plus the current year up to the date of the transfer.

In a carryover-basis transaction, capital gains tax may apply even if the S corporation election has been in effect for more than the three preceding years or since inception (if the S corporation is in existence for less than three years) if the transferor corporation was not an S corporation for the prescribed period preceding the transfer. If a corporation finds itself subject to tax on long-term capital gain, the corporation will be taxed based on one of two available methods:

1. The corporation can pay the corporate income tax rate on its entire taxable income (as if it were not an S corporation).
2. The corporation can pay the capital gains tax (currently 34 percent) on any capital gain in excess of $25,000.

The corporation will pay the lower of the two figures arrived at using these two methods.

Example. X Corp made an election to become an S corporation that became effective at the beginning of the 1986 taxable year. For the previous years of X Corp's existence it had been a C corporation. At the end of the 1988 taxable year, X Corp had a net capital gain of $36,000. X Corp's taxable income for the year totaled $50,000. For 1988, X Corp's capital gains tax will be computed as follows:

Method 1:	Compute corporate tax	$ 7,500
Method 2:	Capital gain in excess of $25,000	$11,000
	Capital gains tax rate	34%
	Capital gains tax	$ 3,740

X Corp will then pay the lesser of the two amounts, in this case $3,740.

7.3 Recognition of Gain Under New Section 1374

The Tax Reform Act of 1986 amended the old Section 1374 to provide a tax on "built-in" capital gains where a C corporation elects S status after December 31, 1986. Ordinary gain and capital gain will be recognized to an S corporation that was formerly a C corporation on a distribution or sale of its property in a complete liquidation to the extent of any "built-in" gains that arose before conversion to S corporation status, which gains are recognized within ten years of the date the election took effect. The new Section 1374 tax may apply even in situations where there is no liquidation. The tax is computed at the maximum corporate rate. The corporation can take into account all C corporation tax attributes, including net operating-loss carryforwards, in the calculation of its tax.

Thus, in effect, any appreciation in a C corporation's assets existing at the date of conversion to S corporation status will generate a tax if assets are sold or distributed in liquidation, if the sale or distribution occurs within ten years of a conversion made after December 31, 1986. Assets subject to the built-in gains tax will include not only those disposed of through sale or exchange but also collection of accounts receivable by a cash-basis taxpayer. The IRS takes the position that these items will be considered a disposition for purposes of triggering this new tax (Ann. 86-128, IRB 1986-51, 22). In addition, the sale of appreciated inventory in the ordinary course of business is subject to this tax. The capital gains tax on "built-in" gains under the Tax Reform Act of 1986 not only lengthens the period from three years to ten years, but the exclusion of the $25,000 of gain is eliminated. There is a transition rule that protects qualifying corporations whose value is less than $5 million on either August 1, 1986, or the date the S election is made. A qualified corporation is one in which more than 50 percent of the stock is owned directly by ten or fewer qualified persons (generally individuals and trusts). Corporations making their S election during the transition period will not be shielded from the built-in gains tax with respect to its ordinary income and short-term capital gain items. Those items may still be subject to the built-in gains tax. If these corporations elect S corporation status before 1989, they can avoid tax on the "built-in" gains. To the extent the S election can avoid tax on "built-in" gains, the special capital gains tax under old Section 1374 would still apply to capital gains recognized within the first three years of election of S corporation status.

7.4 Tax on Passive Investment Income

Passive income is only subject to corporate tax if a corporation has earnings and profits from years when the corporation was a C corporation. For S corporations with C corporation earnings and profits, excess passive income is taxed at the highest corporate rate (34 percent). A corporation's excess passive income can be figured as follows:

- Determine net passive income by subtracting allowable deductions that are directly attributable to the production of the passive income from gross passive income.
- Determine what percentage of gross passive income exceeds the 25 percent of gross receipts limit.
- Multiply the percentage determined above by the amount figured for net excess passive income.

Calculation of Excess Passive Income Tax

During the year, F corporation had the following:

Gross receipts		$200,000
Total passive investment income	$80,000 (A)	
Less:		
Expenses attributable to passive income	20,000	
Net passive income	$60,000 (B)	
25% of gross receipts (200,000 × .25)	$50,000 (C)	

Supp. 1—11/87

$$\left(\frac{\text{Total Passive Income less 25\% of Gross Receipts}}{\text{Total Passive Income}}\right)$$

$$\times \text{ Net Passive Income} = \text{Excess Net Passive Income}$$

$$\frac{80{,}000\ (A) - 50{,}000\ (C)}{80{,}000\ (A)} \times 60{,}000\ (B)$$

$$\frac{30{,}000}{80{,}000} = .375 \times 60{,}000 = 22{,}500$$

22,500	Excess net passive income*
× .34	Highest corporate rate
7,650	Tax on excess net passive income

*Note that the excess passive income subject to the tax may not exceed the corporation's taxable income

8. TAXATION AT THE SHAREHOLDER LEVEL

8.1 Passthrough Items

The principal factor differentiating the shareholders of an S corporation from the shareholders of a C corporation is that the shareholders of an S corporation pay taxes on passthrough items at the shareholder level. Shareholders of an S corporation must take into account the taxable items, similar to those governed by partnership rules under IRC Section 702. However, the partnership and S corporation rules are not identical. Thus, an S corporation shareholder must report his or her pro-rata share of

— Nonseparately computed income or loss (taxable income).

— Items of income, loss, deduction, or credit, the separate treatment of which could affect the shareholder's tax liability (Sec. 1366 (a) (1)).

The following are additional examples of some of the separately stated items that pass through to shareholders for tax years beginning after 1982:

— *Capital gains and losses.* Capital gains or losses pass through to the shareholders as capital gains or losses.

— *Section 1231 gains and losses.* Section 1231 gains (relating to certain property used in a trade or business) are passed through separately, to be combined with the shareholder's other Section 1231 gains or losses.

— *Charitable contributions.* The corporate 10 percent limitation will not apply.
— *Tax-exempt interest.* Such interest passes through and is not taxed to the shareholder when it is received by the S corporation. However, tax-exempt income, which increases basis but does not increase the accumulated adjustments account (AAA) (see section 9.2.2 herein), is treated as distributed only after all accumulated earnings and profits have been distributed (Secs. 1368 (a) (1) (A); 1368 (e) (1) (A)).

  Example: SAM Corporation has ordinary income of $70,000 and tax-exempt income of $20,000 during the first year it elected S status. SAM Corporation has $100,000 of accumulated earnings and profits from years prior to its S election. During the year the corporation distributed $90,000 to its shareholders. The shareholder pays tax on $90,000, because $70,000 is his or her distributable share of the corporation's taxable income. The remaining $20,000 results from the corporation's making a distribution in excess of AAA. The distribution comes out of the corporation's accumulated earnings and profits from the years prior to S election. The $20,000 nontaxable income increases stock basis but not AAA.

— *Foreign tax credit.* Foreign taxes paid by the corporation pass through as such to the shareholders, who claim the taxes either as deductions or credits, subject to the applicable limitations. An S corporation is not eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the S corporation is a shareholder, and these tax credits do not pass through to its shareholders.
— *Credits.* These include the credit for backup withholding on dividends, interest income, and other types of income. In addition, credits for nonconventional sources and for increasing research activities are passed through to the shareholders. Not all types of credits, however, pass through to the shareholders (Section 1374 (c) (1)).
— *Depletion.* S corporations treat depletion as partnerships do; that is, the corporation states such items separately and passes them through to the shareholders.
— *Foreign income and loss.* Domestic and foreign income or losses each pass through separately, without aggregation at the corporate level.
— *Dividends.* Dividends that may be excludable from an individual's income must be separately stated and passed through. The shareholders then apply applicable limitations at the individual level.[2]

8.2 How Shareholders Treat Passthrough Items

As of 1983, all items of income, loss, credit, and deduction passed through to the shareholders are allocated on a per-share, per-day basis.

[2]List reprinted from *S Corporations,* CPE Course Handbook (New York: American Institute of Certified Public Accountants, 1986), pp T6-3–T6-4.

Passed-through items must be reported in the shareholder's taxable year that includes the last day of the S corporation's taxable year. Net operating losses are allocated as other corporate items are, with the exception that each shareholder's ability to deduct losses is affected by his or her basis in the stock (see section 8.3, below). If shares are transferred during the taxable year, the transferee is considered as the owner of the shares on the day of the transfer.

Example: At the beginning of the taxable year, Z Corp had 500 shares of outstanding stock that were owned by two people:

Barbara	200 shares
Elena	300 shares

On June 1, Elena sold fifty shares of stock in Z Corp to Dawn. At the end of the taxable year Z Corp's only passthrough item was its taxable income of $50,000. To calculate each shareholder's share of taxable income, the instructions in Form 1120S suggest the following steps:

— Compute percentages of stock owned for the year:

Barbara		40%
Elena	Before June 1	60%
	After June 1	50%
Dawn	Before June 1	0%
	After June 1	10%

— Compute percentages of the year before and after transaction:

January 1 to June 1	(151/365)	41%
June 1 to December 31	(214/365)	59%

— Multiply each shareholder's percentage of stock owned by the percentage of the year during which they owned them:

Barbara:	40% × 100%	40.0%
Elena:	60% × 41%	24.6%
	50% × 59%	29.5%
Dawn:	10% × 59%	5.9%
		100.0%

— Multiply each shareholder's percentages as determined above by the corporation's taxable income to determine her share of the corporation's taxable income:

Barbara:	40% × $50,000	$20,000
Elena:	(24.6% + 29.5%) × $50,000	$27,050
Dawn:	5.9% × $50,000	$ 2,950
		$50,000

8.2.1 If a shareholder terminates interest

If a shareholder terminates his or her entire interest in the corporation and if both the person who terminated the interest and all other persons who were shareholders in the corporation at any time during the year consent, under Section 1377 (a) (2) the corporation can elect to treat the taxable year as if it consisted of two separate years, with the first year ending on the date of the shareholder's termination. The election to treat the taxable year as two separate years does not terminate the S corporation election and only one corporate return (Form 1120S) has to be filed for the year. The treatment of the S corporation year as two separate taxable years results in the books' being closed and the income or loss accruing before the shareholder left the corporation will be allocated among all shareholders, and the income or loss accruing after the shareholder terminates interest will be allocated only to the remaining shareholders. What the election does is provide an alternative method of allocating passthrough items. If no election is made then the income or loss is computed under the prorata method (see section 4.3).

Example: Y Corp is a calendar year S corporation, with 100 shares of common stock outstanding. John owns fifty shares all year. Mary owns fifty shares until September 30th when she sells all of her shares to Steve. The corporate accounting records show that the corporation had $30,000 profit at transfer date and experienced a $10,000 loss after the transfer date, making a profit of $20,000 for the year ended December 31. The results to Mary and Steve will be different, depending upon which method is used for allocation of income and loss.

Method 1: Prorata Mathematical Allocation Formula

	1/1 to 9/30	10/1 to 12/31	Total
Number of days	273	92	365
Ratio (number of days) / 365	.7479	.2521	1.00
Income	$14,958	$5,042	$20,000
Allocated as follows			
John	$ 7,479	$2,521	$10,000
Mary	7,479		7,429
Steve		2,521	2,521
	$14,958	$5,042	$20,000

Method 2: Use of Actual Accounting Records and Election under Section 1377 (a) (2)

The corporation elects to treat the tax year as if it consisted of two years, with the first one ending on the date of the shareholder's termination. John, Mary, and Steve must consent to the corporation's election. The income for each shareholder is computed as follows:

	1/1 to 9/30	10/1 to 12/31	Total
Income (or loss) for period	$30,000	$(10,000)	$20,000
Allocated as follows			
John	$15,000	$ (5,000)	$10,000
Mary	15,000		15,000
Steve	———	(5,000)	(5,000)
	$30,000	$(10,000)	$20,000

8.2.2 If a shareholder dies

If a shareholder dies, his or her final return will include the prorata share of passthrough items up to date of death and will be included on the decedent's final return (Section 1366 (a) (1)). Items for the remainder of the year will pass through to the estate or the person acquiring the stock.

8.3 Shareholder's Basis

8.3.1 Basis in stock

Basis is important because it measures the amount of S corporation loss that is deductible by a shareholder. Under current law, the basis of a shareholder's S corporation stock is computed as follows:

— Original cost or basis, however arrived at

— Increased by

Nonseparately computed income (Section 1367 (a) (1) (B)). (This would be the shareholder's share of the corporation's "taxable" income.)

Separately stated items of income (Section 1367 (a) (1) (A)). (This includes capital gains, Section 1231 gains, and the like.)

Excess of the deductions for depletion over the basis of the property subject to the depletion (Section 1367 (a) (1) (C)).

— Decreased by

Nonseparately computed loss (Section 1367 (a) (2) (C)).

Separately stated items of deduction or loss (Section 1367 (a) (2) (B)) such as capital losses and Section 1231 losses.

Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account (Section 1367 (a) (2) (D)).

The amount of the shareholder's deduction for depletion of oil and gas wells under Section 611 (Section 1367 (a) (2) (E)).

Distributions (that is, nondividend distributions), which are not includable in the shareholder's income (Section 1367 (a) (2) (A)). This category includes distributions of items that have already been taxed to the shareholder, such as the accumulated adjustments account (AAA) and previously taxed income (PTI), and includes distributions that are applied against stock basis to the extent the basis does not go below zero).

8.3.2 Basis in debt

When losses are passed through, they first reduce the basis of a shareholder's stock; when the stock basis is zero, further basis reductions are made in shareholder loans to the corporation. There can be no negative basis in which losses exceed basis. The shareholder's basis in stock cannot be increased until any reduction of basis in debt has been restored (this only applies to debt basis for years after 1982). Basis would increase as a result of passthrough of S corporation income. The key change made by SSRA is that losses not deductible by reason of insufficient basis in stock or indebtedness are not lost forever but may be carried forward and deducted in later years when basis increases. In contrast to a partner, a shareholder in an S corporation only has basis in indebtedness of the S corporation to that shareholder (partners have basis in partnership indebtedness to others for which they may be held personally liable). The rule that shareholders only obtain basis for amounts they loaned the corporation, while partners have basis for all partnership debts for which the partners are personally liable is the reason that partnerships have been the preferred vehicle for most tax-advantaged investments even after SSRA. Note that the Tax Reform Act of 1986 has put limitations on losses and credits from passive activities.

8.3.3 Reduction of basis of individual shares

Whether the shareholder basis is stock or debt, it is first necessary to reduce the individual basis in shares to which the loss can be attributed and then the basis in debt. The following example shows the calculations involved in figuring the reduction of basis of individual shares.

Example: At the beginning of the taxable year Sue owned three shares of stock in Q Corp. During the year Sue sold one of her shares and later purchased another share. At the end of the taxable year Sue was notified that her share of the corporation's losses was $2,000. Sue's basis in each of her shares after loss allocation is calculated as follows:

Share:	#1	#2	#3	#4	Total
Days shares held during year.	365	365	182	92	1,004
Basis of shares beginning of year:	$500	$800	$400	$900	$2,600
Loss allocation: Share 1: (365/1004) × $2,000 Share 2: (365/1004) × $2,000 Share 3: (182/1004) × $2,000 Share 4: (092/1004) × $2,000					
	$727	727	363	183	2,000
Basis minus loss:	(227)	73	37	717	600
Reallocate subzero basis to: Share 2: (073/827*) × $227 Share 3: (037/827) × $227 Share 4: (717/827) × $227 *827 = 73 + 37 + 717					
	227	(20)	(10)	(197)	0
Basis after loss allocation:	$0	$53	$27	$520	$600

*Example reprinted from *S Corporations* CPE Course Handbook (New York: American Institute of Certified Public Accountants, 1986), p. T7-7

A separate basis computation for each lot or block of stock held by the shareholder is consistent with the case of *W. Taylor Johnson*, 435 F. 2d 1257 (4th Cir. 1971). However, an AICPA task force has recommended to the Internal Revenue Service that the proposed regulations, when issued, permit an S corporation shareholder to use a composite of his or her stock holdings for the basis of computation.

If a shareholder's basis in debt has been reduced as a result of passthrough losses, repayment received from the corporation on the debt will generate taxable gain to the shareholder to the extent capital gain classification is relevant. The debt has to be evidenced in writing in order to create capital gain on repayment as opposed to ordinary income.

8.4 Fringe Benefits

Any person who owns more than 2 percent of the stock of an S corporation is treated like a partner when it comes to fringe benefits. A person who is a 2-percent shareholder at any time during the S corporation's taxable year must treat fringe benefits as income. S corporation shareholders cannot exclude fringe benefits paid to 2-percent shareholders unless the fringes were being paid before September 28, 1982 (beginning in 1988, however, no S corporations will be allowed to exclude fringe benefits paid to 2-percent shareholders). The following is a list of all such fringe benefits:

— Accident and health plans and medical expenses (Section 105-106)

— Group-term life insurance of $50,000 (Section 79)

— Meals and lodging furnished for convenience of the employer (Section 119)

— Death benefits of up to $5,000 paid to a deceased employee's beneficiary (Section 101 (b))

9. DISTRIBUTIONS

One of the advantages of operating an S corporation is the fact that income is taxed only once. Generally, income escapes tax at the corporate level and the shareholder pays tax on it by reporting it on his or her personal income tax return.

9.1 By a Corporation With No Accumulated Earnings and Profits

Distributions are handled differently by S corporations with earnings and profits and S corporations without accumulated earnings and profits. (See section 9.2 below for corporations with accumulated earnings and profits.) For S corporations that have no earnings and profits, the application of distributions is

— As a nontaxable return of capital to the extent of the shareholder's basis.

— As a gain from the deemed sale or exchange of stock (capital gain) (Sec. 1368 (b)).

The taxable or nontaxable characteristics of a distribution cannot be determined until the taxable year ends. First, basis of the stock is adjusted by the passthrough items, then distributions are taken into account.

9.2 By a Corporation With Accumulated Earnings and Profits

9.2.1 Order of applying distributions

An S corporation does not generate earnings and profits (E & P) for any taxable year beginning after 1982 (Sec. 1371 (c)). A distribution of

E & P is a taxable dividend to the recipient. An S corporation without E & P *cannot* distribute a taxable dividend.

S corporations (a prior C corporation or pre-SSRA S corporation) with earnings and profits apply distributions in the following order:

1. As a distribution of AAA (see section 9.2.2, below), which is treated in the same manner as a distribution from an S corporation without earnings and profits (return of capital up to basis in stock and a disposition of stock subject to capital-gain treatment to the extent they exceed basis) (Sec. 1368 (c) (1)).
2. As a dividend to the extent of the corporation's earnings and profits (Sec. 1368 (c)) (ordinary dividend income).
3. As a nontaxable reduction of basis to the extent of the remaining basis, if any, in stock (tax-free—reduces basis of stock).
4. As a taxable gain from the deemed sale or exchange of stock subject to capital gain treatment (Sec. 1368 (c) (3)).[3]

For S corporations with previously taxed income (PTI) from years prior to 1983, the distribution rules from pre-SSRA years are still in effect, and distributions are applied in the following order:

— AAA

— PTI

— Dividend to extent of E & P

— Nontaxable return of capital to the extent of remaining basis

— Taxable disposition of stock

9.2.2 Accumulated Adjustments Account (AAA)

The purpose of the AAA is to maintain a running tabulation of an S corporation's ability to distribute profits tax-free to shareholders, because the income has already been taxed. The AAA starts at zero on the first day of an S corporation's first taxable year beginning after 1982. For subsequent years the AAA will have a positive balance from earnings or a negative balance (deficit) where there are accumulated post-1982 S corporation losses. AAA is adjusted by the same amounts that affect a shareholder's stock basis (see section 8.3.1, above). However, tax-exempt income does not increase AAA and related expenses do not reduce it. Tax-exempt income therefore cannot generally be distributed tax-free if there are accumulated earnings and profits.

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3 Reprinted from *S Corporations,* CPE Course Handbook (New York American Institute of Certified Public Accountants, 1986), p T8-7

9.3 Property Distributions

On distributions of appreciated property by an S corporation that are passed through to the shareholders, the gain is recognized to the corporation just as if it had sold the property to the shareholder at its fair market value (Sec. 1363 (d) (a)). No gain is recognized on distributions of appreciated property in complete liquidations (Sec. 1363(e)).

9.4 Post-Termination Transition Period Distributions

Following the termination of an S corporation's election, the corporation may still make cash distributions (not in property) during a post-termination transition period, and they are to be applied against stock basis to the extent of AAA. This gives the corporation an escape hatch, so it has some time to distribute its AAA (which has already been taxed) as a tax-free return of capital in the event the election is revoked or involuntarily terminated. Section 1377(b) defines this period as

— The period beginning on the day following the last day of the corporation's last taxable year as an S corporation and ending on the later of

  The day that is one year after such last day.

  The due date for filing the return for such last year as an S corporation (including extensions).

— The 120-day period beginning on the date of a determination that the corporation's election under Section 1362(a) had terminated for a previous year. (A determination is a court decision that has been finalized, a closing agreement, or an agreement between the corporation and the IRS that the election had ceased to be valid in a prior year.)

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SECURITIES REGULATION

SECURITIES REGULATION

1. INTRODUCTION

1.1 Purpose

Originally intended to protect investors by assuring that they were provided with the information necessary to make informed investment decisions, securities regulation in the United States has expanded to encompass:

- Offerings of securities in both original issuances and as secondary distributions
- The information a prospective investor is entitled to receive
- The information an investor is entitled to receive periodically and when significant events happen
- Trading in securities
- Securities exchanges
- Self-regulatory institutions active in securities matters
- Proxy solicitation
- Investment advisers and investment newsletters
- Broker-dealers
- Insider trading and trading by any person who has inside information
- Fraudulent and manipulative use of financial statements in the buying or selling of securities

1.2 Scope

In the United States, far-reaching power to regulate issuance of and trading in securities is given to a federal agency, the Securities and Exchange Commission (SEC). The SEC not only administers the statutory provisions of the federal securities acts but also wields considerable power through the rule-making prerogatives delegated to it. The federal securities acts are these:

- *The Securities Act of 1933*, which requires registration with the SEC of publicly offered securities. The act contains antifraud provisions that apply to accountants and other persons involved with the process of registration.
- *The Securities Exchange Act of 1934*, which requires registration of securities prior to their trading on an exchange as well as of certain

over-the-counter securities in which there is a significant trading interest. The act also regulates broker-dealers, the national securities exchanges, and associations of securities dealers. Its antifraud provisions apply to persons, such as accountants, involved in securities transactions carried out by use of the mail, telephones, or any instrumentality of interstate commerce.

— *The Trust Indenture Act of 1939,* which requires that an independent trustee be appointed for publicly offered debt securities.

— *The Investment Company Act of 1940,* which requires the registration of investment companies. Their financial statements must be audited by independent accountants.

— *The Investment Advisers Act of 1940,* which requires registration with the SEC of persons deemed to be investment advisers, including accountants in some cases.

Significant attention is devoted in this chapter to the three securities acts of greatest importance to accountants and to two other federal laws with potential impact on accountants:

— The Securities Act of 1933 (cited as the 1933 act)

— The Securities Exchange Act of 1934 (the 1934 act)

— The Investment Advisers Act (the Advisers act)

— The Foreign Corrupt Practices Act (FCPA)

— The Racketeer Influenced and Corrupt Organizations Act (RICO)

All state jurisdictions and Puerto Rico (but not the District of Columbia) require in some form the registration of securities. An official, whose title varies among the jurisdictions, is designated to administer these laws. Some uniformity in state law has been achieved through the adoption of major portions of the Uniform Securities Act by thirty-one jurisdictions.

2. DEFINITIONS

The following terms appear within the context of this chapter.

Accountant. The federal securities acts refer throughout to *independent public accountant,* a person who—by SEC policy—is almost always a certified public accountant.

Accounting and Auditing Enforcement Release (AAER). Since 1982, the AAERs have been the means by which the SEC announces enforcement actions against accountants.

Accounting Series Release (ASR). Accounting Series Releases were used until 1982 by the Securities and Exchange Commission to communicate matters of interest to members of the accounting community. They included matters as diverse as interpretations concerning SEC Regulation S-X and notification of disciplinary action against accountants. They were replaced by two new series: Financial Reporting Releases and Accounting and Auditing Enforcement Releases. In 1982, portions of the previously issued ASRs that retained relevance were reissued in the SEC's Codification of Financial Reporting Policies.

Accredited investor. An accredited investor is one for whom the disclosure requirements associated with registration are unnecessary in most circumstances. Because of their bargaining power and their assumed ability to access information on their own, accredited investors are expected not to need the protection afforded by the registration process. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions of Securities and Exchange Commission (SEC) Rules 505 and 506 and Section 4(6) of the 1933 act. (See section 4.5.1 of this chapter.)

Blue sky laws. State laws dealing with the regulation of securities are known as blue sky laws, a phrase that originated more than fifty years ago in a judicial comment denouncing speculative schemes that were no more tangible than "so many feet of blue sky." In this chapter *blue sky law* will be used interchangeably with *state law* to refer to the applicable laws at the state level that govern issuance and trading of securities.

Certification. In SEC-related matters, it is common to refer to the independent auditor's report as a certification and to say that the auditor has certified the statements. In other contexts, accountants themselves generally avoid these terms on the grounds that they connote too strong an endorsement of accuracy. SEC Regulation S-X defines *certifed* as "examined and reported upon with an opinion expressed by an independent public or certified public accountant."

Comfort letter. The contract between a securities issuer and its underwriter commonly requires that the issuer's public accountant provide a comfort letter to the underwriter. Underwriters request comfort letters not only to acquire information but also to show their reliance on the auditors. Comfort letters are not required by the SEC or by any of the securities acts. Standards to be followed for the accountant's review that culminates in the comfort letter are expressed in Statement on Auditing Standards No. 49, *Letters for Underwriters* (American Institute of Certified Public Accountants AICPA *Professional Standards*, AU, sec. 634).

Due diligence. Section 11(b) of the 1933 act provides a defense for public accountants and others who are charged in a civil action on account of a false registration statement. This due-diligence defense provides that no person shall be liable who shall sustain the burden of proof "that he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true. . . ." The standard for determining reasonableness is that of a prudent person in the management of his or her own property. The review performed by public accountants that helps in establishing their due diligence is often called an S-1 review, after SEC Form S-1, the basic registration form used by nonlisted companies.

Electronic Data Gathering and Retrieval System (EDGAR). A pilot SEC program to explore the ramifications of electronic filing. The SEC staff visualizes that use of EDGAR will permit many of the filings required by securities law to be made by direct electronic transmission from the issuer or perhaps his or her attorney, accountant, or printer.

Financial Accounting Standards Board (FASB). The board issues releases known as Statements of Financial Accounting Standards (SFAS) and interpretations thereof, both often referred to simply as FASBs. These pronouncements have explicitly been recognized by the SEC as constituting generally accepted accounting principles. In other words, financial statements submitted in filings to the SEC are expected to conform to the FASBs and to the SEC's accounting rules expressed in Regulation S-X.

Financial Reporting Releases (FRR). FRRs have replaced Accounting Series Releases as the means by which the SEC communicates its views on accounting and auditing matters that need special treatment in financial statements filed with the commission.

Foreign Corrupt Practices Act (FCPA). The FCPA prohibits payments or offerings, by companies required to report to the SEC, of "anything of value" to foreign officials, political parties, or candidates for the purpose of influencing decisions of the foreign government. In order to facilitate the detection of illegal payments, the act requires that all companies reporting to the SEC keep their accounting records in reasonable detail and also mandates that they maintain an adequate system of internal accounting controls.

Independent public accountant. Independent auditors who certify financial statements filed with the SEC are held to a high standard of independence. They violate the rules of the SEC if they

— Have any direct or material indirect financial interest in the enterprise whose statements they audit.

— Are connected with the enterprise as promoter, underwriter, voting trustee, director, officer, or employee.

— Post journal entries or perform any other bookkeeping or controllership functions.

(Text continued on page 155)

The rules regarding financial interest generally apply also to any member of the accountant's firm who participates in the audit and to close family members of the principals of the firm. The public accountant who regularly performs some bookkeeping functions for and then audits the statements of a non-SEC-reporting enterprise may prepare or assist in preparing the statements for an SEC filing but may not certify them.

Insider trading. Insider trading is trading and profiting while in the possession of information unavailable to the public. Trading in the securities of public companies by persons deemed to be insiders must be reported to the SEC. Under Section 16(b) of the 1934 act an insider who purchases and sells or sells and then purchases, within a six-month period, equity securities of a company that has a class of equity securities registered under the act will incur a liability to the corporation for any profit realized. The term *insider* means a director or officer, including president, vice president, treasurer, secretary, comptroller, and any other person who performs functions corresponding to those performed by these officers.

In case law interpretations of SEC's Rule 10b-5, even persons who are not officers may be treated as "constructive insiders" subject to penalties if they turn a profit or reduce a loss by buying or selling securities while in possession of material nonpublic information. SEC Rule 10b-5, Rule 14e-3, and the Insider Trading Sanctions Act of 1984 provide for disgorgement of profits and for civil and criminal penalties. Accountants who, in the course of their professional practice, learn of significant corporate developments, including reports of earnings, should be careful not to purchase or sell that company's securities until the developments are announced to the public. There are no definitive guidelines by which to determine the length of this waiting period: the American Stock Exchange has suggested a twenty-four-hour wait after general publication of the release in a national medium or forty-eight hours when publication is less widespread.

Investment contract. See *Securities.*

Letter stock. Stock acquired by a buyer who furnished to the seller a letter stating that the buyer acquired the securities for investment and not with a view to distribution. (See section 4.6, herein, Secondary Transactions.)

Prospectus. Any offer made in writing to sell securities constitutes a prospectus and may fall within SEC jurisdiction (Sec. 2, 1933 act). As ordinarily used, the term refers to the document required by securities law to be provided to prospective buyers of securities that are the subject of a registration statement. It is unlawful to deliver securities subject to registration to a buyer through the mails or otherwise in interstate commerce without sending a prospectus along with them unless the buyer has previously received one. The prospectus must meet specifications of the 1933 act. An offering circular must be provided for filings made under Regulation A. The equivalent document under Regulation D is an abbreviated disclosure document described in Rule 502(b).

Proxy. A proxy allows someone entitled to vote on any corporate matter—for example, through ownership of common stock—to designate another party to be present and to cast the vote. Such matters as the creation of a proxy, its effective period, and means of revocation are ordinarily dealt with under state law. Proxies may be solicited by incumbent management or by some other person. By Section 14(a) of the 1934 act the SEC regulates the solicitation of proxies directed to more than ten people.

Annual reports must accompany or precede proxy solicitations, made on behalf of management, that relate to an annual meeting in which directors are to be elected. Copies of this annual report must be mailed to the SEC for its information. Rules of the New York and the American Stock Exchanges and of the National Association of Securities Dealers must be consulted concerning transmittal of proxy material to customers whose stock is held in a broker's or banker's name (street name).

Racketeer Influenced and Corrupt Organizations Act (RICO). RICO, intended to protect businesses against organized crime, has turned out to have a particularly broad reach. In the fifteen years since it was enacted, however, RICO has been used against legitimate businesses such as brokers, banks and investment bankers, lawyers, insurance companies, manufacturers, and public accountants, including General Motors, American Express, Prudential Insurance, and at least two of the Big Eight public accounting firms. (See section 6, Other Federal Securities-Related Acts, below.)

Red herring. Essentially a preliminary offering prospectus. Every offer in writing of securities must contain information specified in Section 10 of the 1934 act. Some of this information may not yet be available when issuers and their underwriters desire to create interest in an upcoming issue that has been filed for registration but is not yet effective. In these circumstances, if a registration statement is on file with the SEC, a preliminary prospectus is authorized. This document includes on its face a legend in red ink stating that the registration statement has not become effective and that a formal offer to sell can only be made after the effective date of the registration. Ordinarily, information about offering price, commissions to dealers, and proceeds accruing to the issuer is excluded from this red herring prospectus. The antifraud provisions of the 1934 act require that brokers or dealers must deliver, at least forty-eight hours prior to the mailing of the sale confirmation, a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale (SEC Rule 15c-2-8).

Registration. Registration is the process of filing with the regulatory authority adequate information about securities and the company that issues them. At the federal level, registration statements are filed with the SEC. The SEC neither approves nor disapproves of the company or its securities; it passes only on the adequacy of the disclosures. State laws may also require registration. Exemptions from state registration are frequently found for companies that report to the SEC—for example, for securities senior to or substantially equivalent to securities already traded on one of the principal stock exchanges. Full registration with the state is usually unnecessary where adequate information is already available. Although registration may not be required, a filing with the state may still be required. Both the 1933 act and the 1934 act deal with federal registration.

Registration by coordination. Most state laws allow registration by coordination—considerably abbreviated state registration (or none at all)—for securities registered in compliance with the federal securities acts.

Regulations and rules. For purposes of organization, many SEC rules are grouped within regulations. For example, Regulation D contains Rules 501 through 506.

Regulation A. Ostensibly, SEC Regulation A provides an exemption from registration for security issues of less than $1.5 million per year. In fact, notification and disclosure requirements under this regulation make it more in the nature of a miniregistration, less complex and expensive than full registration. Financial statements included in a Regulation A filing generally need not be certified.

Regulation D. SEC Regulation D consists of a series of six Rules, 501 through 506, that became effective in April 1982. Rules 504, 505, and 506 establish three exemptions that replace the exemptions previously available under Rules 146, 240, and 242. Details of these exemptions may be found in section 4.5, Exemptions From Registration. The exemptions relate to

— Issuance of $500,000 of securities by companies not otherwise reporting to the SEC (Rule 504).

— Issuance of $5 million of securities in a twelve-month period (Rule 505).

Regulation S-K. This regulation, copies of which are available free from the SEC, contains instructions for filing forms under the securities acts of 1933 and 1934. Specifically, Regulation S-K states the requirements applicable to the content of the nonfinancial-statement portions of registration statements filed under the 1933 act and registration statements, annual reports, proxy statements, and "any other documents required to be filed" under the 1934 act.

Regulation S-X. The SEC details its accounting rules—matters of detail and presentation—in Regulation S-X. For example, Article 5 tells accountants to "State separately amounts receivable from (1) customers (trade); (2) related parties; (3) underwriters, promoters, and employees (other than related parties) that arose in other than the ordinary course of business; and (4) others." In the case of substantive accounting matters the SEC expects conformity with generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board. The SEC considers these pronouncements to have "substantial authoritative support." Regulation S-X may be obtained at no charge from the Publications Section, Securities and Exchange Commission, Washington, D.C. 20549.

Restricted securities. Restricted securities are securities "acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering, or securities acquired from the issuer that are subject to the resale limitations of Regulation D, or securities that are subject to the resale limitations of Regulation D and are acquired in a transaction or chain of transactions not involving any public offering" (SEC Rule 144). Subsequent sales of restricted securities will ordinarily require prior filings with the SEC unless an exemption can be found by the seller. (See also section 4.6 on Secondary Transactions and Rule 144, below.)

Scienter. Scienter, a term frequently used in federal securities litigation, roughly connotes guilty intent. It can be contrasted with the lesser degree of culpability called negligence, which implies carelessness or fault but no intent or knowledge of a deficiency in financial statements. For public accountants to be liable under the SEC's Rule 10b-5, their scienter must be established; not so for liability under Section 11 of the 1933 securities act, which refers to a "due diligence" defense by an accountant. This defense, in effect, establishes a negligence standard. Whether or not "recklessness" or "reckless disregard of the consequences" will be held by the courts to constitute scienter is as yet unsettled.

Secondary transactions. Subsequent sales by persons who purchase from the issuer of securities are called secondary distributions (or transactions). Proceeds of secondary distributions do not benefit the issuer of the securities. In certain cases secondary distributions must be registered with the SEC. For example, securities originally issued in an exempt transaction generally must be registered before they are resold publicly. Also, substantial blocks of securities sold by a controlling person must be registered. See also section 4.6 on Secondary Transactions and Rule 144, below.

Securities. Definitions of a security tend toward similarity in the various federal securities acts and the state blue sky laws. Since the securities laws are applicable only if a security is involved, it is imperative to know if a proposed financial transaction involves one. *Security* is defined in the 1933 act to include any

— Note, stock, treasury stock, bond, debenture, or evidence of indebtedness.

— Certificate of interest or participation in any profit-sharing agreement.

— Collateral-trust or preorganization certificate, or subscription.

— Transferable share, investment contract, voting-trust certificate, or certificate of deposit for a security.

— Fractional undivided interest in oil, gas, or other mineral rights.

— Put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities.

— Put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency.

— Any ownership interest or instrument known as a "security."

— Certificate of interest or participation, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing (Section 2(1)).

The term *investment contract,* included in the definition, has been held by the courts to encompass a broad variety of transactions, including investment interests offered for sale in

An orange grove and in other citrus and fruit trees
A condominium
Chinchillas, mink, beavers
Franchises
Gold and silver bullion
Limited partnerships
Rights in oil, gas, and other mineral production
Purchase-money mortgages
Cemetery lots purchased for resale
Self-improvement courses

Whiskey warehouse receipts
Variable annuities and variable life insurance policies, where related to performance of a securities portfolio

Interests as a general partner in a partnership are, in most cases, not securities. The Supreme Court has also held the following, although similar to contracts that have been held to be securities, not to be securities:

— Shares in a nonprofit co-op housing corporation
— Interests in a noncontributory defined benefit pension plan

There have been apparently contradictory decisions among the different federal judicial circuits as to what constitutes a security. The issue is frequently litigated and no fail-safe test can be applied, particularly by the nonprofessional. Some guidance can be attained by asking whether the proposed transaction contemplates (1) an association of investors in a common enterprise and (2) the realization of profits solely through the efforts of third parties. An affirmative answer to both of these questions almost surely identifies an investment contract and, thus, a security. Whenever a client proposes to solicit funds from others for the purpose of managing or investing these funds to generate earnings or profits, the astute financial adviser will recognize that a security is probably involved and securities law must be considered.

Securities and Exchange Commission (SEC). The SEC was established by the Securities Exchange Act of 1934 to administer the various securities acts. There are regional offices and regional administrators at several locations. (See section 5.2, herein.)

Securities Investor Protection Corporation (SIPC). All broker-dealers registered with the SEC are members of SIPC, a public corporation. SIPC liquidates insolvent broker-dealers and assures payment of their customers' claims up to $500,000 per account (subject to a limit of $100,000 in "free credit balances" or cash).

Shelf registration. In the process known as a shelf registration the registration statement is filed with the SEC but the securities are "put on the shelf"—that is, delayed in their issuance. Shelf registration benefits issuers who wish to choose the most advantageous time for the offering, giving consideration to the effect of interest rate and stock exchange fluctuations. Requirements for shelf registration are spelled out in SEC Rule 415.

Small issues. The concept of small issues, particularly in relation to exemptions from federal securities registration, depends on context and does not have a definite quantification. The threshold amounts designated for exemption from registration under certain conditions are these:

— SEC Rule 504: $500,000.

— SEC Rule 505: $5 million.

— SEC Regulation A, which provides for simplified registration when the amount of securities offered is not over $1.5 million.

— The intrastate exemption (Section 3(a)(11) and Rule 147) tends to result in relatively smaller offerings.

— Form S-18, which provides a simplified filing document for offerings up to $7.5 million.

Tender offer. Although not defined in the securities acts, tender offer refers to an offer to buy, ordinarily, a significant portion of the shares of a corporation. Offers that could result in the acquisition of more than 5 percent are subject to regulation. The term *takeover offer* more clearly specifies that control of the target corporation is desired. Any person planning such an offer for registered securities must file with the SEC, prior to the tender, copies of all advertisements and other documents to be used in the solicitation. Persons opposed to the tender must file their responses.

Tombstone ads. Black borders are sometimes placed around the brief advertisements authorized by SEC Rule 134. The borders and the brevity of the ads have caused them to be labeled "tombstone ads." Often they do not appear until after the effective date of the registration and sometimes after the issue is sold out. In that case they serve as testimony of the effectiveness of the underwriter in putting the issue to rest.

Underwriter. In the typical arrangement for distribution of newly issued securities, an investment banker called an underwriter will undertake the task of coordinating the distribution. He or she may organize a group or syndicate of underwriters to assist in the task. The underwriter may contract to take the issue for resale at his or her own risk (firm underwriting) or may promise only to use his or her best efforts. (See also section 4.2 on the Process of Registration, below.)

3. FEDERAL SECURITIES REGULATION: OVERVIEW

The Securities and Exchange Commission (SEC) administers the five federal securities acts. The commission's principal office is in Washington, D.C., and there are nine regional and eight branch offices. The SEC has considerable rule-making authority, which it has frequently exercised to expand upon or clarify the securities acts. Generally, the staff of the SEC has taken an expansive posture toward its role in the administration of securities law.

Distribution to the public of securities not previously traded is regulated by the Securities Act of 1933. This act, together with the rules of the Securities and Exchange Commission, specifies the disclosures necessary to register a proposed new issue of securities. Unless exempted, registration is necessary to avoid penalties provided by the act. This act also regulates both the use of prospectuses and fraud in connection with public offerings of securities.

The Securities Exchange Act of 1934 requires the registration of both securities prior to listing and trading on a stock exchange and over-the-counter securities in which there is significant trading interest. Under this act there are continuing requirements to disclose significant corporate developments. This act also requires broker-dealers, national securities exchanges, and associations of securities dealers such as the National Association of Securities Dealers (NASD) to register with the Securities and Exchange Commission. It also regulates fraud in connection with the purchase and sale of securities and generally provides the mechanism with which the SEC oversees trading in securities.

The Trust Indenture Act of 1939 concerns public offerings of debt securities, for which it requires the establishment of independent trustees pursuant to trust agreements called indentures.

The Investment Company Act of 1940 requires registration of investment companies such as mutual funds and imposes conditions relating to their operation.

The Investment Advisers Act of 1940 requires registration of investment advisers who have more than fourteen clients unless their activities are exclusively intrastate.

Of particular interest to accountants will be the 1933 and 1934 securities acts and the Investment Advisers Act. These will be discussed in detail below.

4. THE SECURITIES ACT OF 1933

4.1 The Purpose of Registration Under the 1933 Act

Registration of a new issue of securities with the SEC provides potential investors with a source of information about their investment. The 1933 act provides for civil and criminal penalties to discourage misrepresentation in connection with offerings of securities. The role of the Securities and Exchange Commission is to oversee the process of registration, essentially to determine if the registration documents are complete, without passing in any way upon the suitability or safety of the investment. Purchasers of securities who have scrutinized the mandated registration documents may be foolish in their investment, but they will not have been misinformed—at least, that is the intent of the 1933 act.

4.2 The Process of Registration

When securities are offered to the public by the issuer, registration is ordinarily required—which means the federal securities acts and the rules and regulations of the Securities and Exchange Commission must be complied with. It is unlawful to use the instrumentalities of interstate commerce (including telephone and mail) to sell unregistered securities. State securities laws must also be consulted. The decision by a closely held corporation to go public is not one to be undertaken without detailed consideration of the pros and cons. Expansion of the sources of capital and national, or at least regional, recognition are partially offset by the expense of the registration process and the ongoing complexity of continuous reporting, coupled with the partial relinquishment of control to outsiders. Clients considering the desirability of going public can consult for advice:

— Commercial bankers

— Certified public accountants

— Stockbrokers

— Investment bankers

— Registered investment advisors

— Attorneys, particularly those experienced in securities law

— Entrepreneurs who have recently gone public

— Books cited in the references section of this chapter

Ordinarily, publicly offered securities will be marketed through an underwriter. Underwriters are usually stockbroker-dealer firms with investment-banking departments. Commercial banks cannot function as underwriters. A group of underwriters, headed by one or more lead underwriters, will handle big issues; the team may be supplemented by broker-dealers who act solely as sales agents. Underwriter compensation packages typically include, but are not limited to:

— Commissions

— Discounts on the securities they underwrite

— Expense allowances

— Stock purchase warrants

— Rights of first refusal on future securities issues

The reasonableness of compensation received by its members acting as underwriters is regulated by the National Association of Securities Dealers (NASD). A 1981 NASD survey reports typical compensation at about 12.5 percent for a firm underwriting of $5 to $6 million. Stated as a percentage, compensation is slightly higher for smaller offerings and for best-effort underwriting; slightly lower for larger offerings. There are two types of underwriters:

— Firm-commitment underwriters, who agree to buy the securities from the issuer at a predetermined price, then undertake the risk of reselling them.

— Best-effort underwriters, who promise only to try to sell the securities as agents for the issuer. Both the smallest companies, which cannot attract a firm-commitment underwriter, and the best-established companies, which do not need one, use the best-effort method.

Assuming that no exemptions from registration can be found and the abbreviated procedures of Regulation A are not applicable, the process of a firm underwriting can be visualized like this:

— The firm desiring to raise capital meets with an investment banker.

— The banker gives oral assurance (or a letter of intent) expressing interest.

— Banker, issuer, legal counsel, and independent public accountants work together to prepare a registration statement and prospectus. (Preparation of these materials is time-consuming and—because of the expertise required of many of the participants and the liability to which they expose themselves—expensive.)

— The registration statement is filed with the SEC, a preliminary prospectus is issued, and expressions of investors' interest are sought by the underwriter.

— The SEC's Division of Corporation Finance scrutinizes the filings and may issue a deficiency letter, a comment letter, a stop order, or may find the filing acceptable as it is.

— After the filing of any necessary amendments, the registration statement becomes effective. (Theoretically, this occurs twenty days after the original filing; however, amendments required by the SEC staff may extend the date or the issuer may take advantage of procedures to delay the effective date.)

— Underwriter and issuer sign a firm agreement for a closing date and price. The underwriter begins to accept customers' offers to buy.

— The issuer receives a check from the underwriter and sale of the securities to the public is begun by the underwriter.

Registration is an expensive process. The issuer, the underwriter, and sometimes the public accountant will each be represented by his or her own legal counsel. Masses of information must be accumulated concerning the issuing company—including its history, current operations, accounting policies, major customers, labor relations, affiliated companies, management background, qualification, and compensation, as well as its financial arrangements, contracts, patents, and existing or potential litigation. Requirements to be considered are those of the SEC, of the National Association of Securities Dealers, and of state blue sky laws. Only legal counsel experienced in securities matters should be relied upon for guidance through this process.

4.3 Contents of the Registration Statement

The three basic registration forms are SEC Forms S-1, S-2, and S-3. They differ in the amount of detail required, primarily because the latter two allow other filings with the SEC to be included by reference (that is, referred to but not attached to the S-2 or S-3 filing). Registration statements contain

— A facing page appropriate to the particular SEC form being utilized, ordinarily displaying the names of the issuer and its legal counsel and the calculation of the registration fee.

— A prospectus containing financial data and making up the bulk of the registration. (See Section 4.4, herein.)

— A cross-reference sheet coordinating registration form and prospectus.

— Selected information not required in the prospectus, including expenses of the distribution and data about unregistered securities sold within three years.

— "Undertakings" appropriate to the filing form being used, as prescribed by Item 512 of Regulation S-K. (In effect, undertakings consist of promises on the part of the registrant, introduced with the clause "The undersigned registrant hereby undertakes," for example, "to deliver . . . the latest annual report that is incorporated by reference in the prospectus.")

— A signature page.

— Exhibits, including consent documents from experts named in the filings.

4.4 Contents of the Prospectus

The amount of detail required in a prospectus differs somewhat, depending on the SEC form on which the filing is made. For instance, Form S-2 allows the incorporation of financial statements by reference to those statements included in a recent Form 10-K filing (the annual filing required under the 1934 act). This list of matters to be included in a prospectus is taken from Regulation S-K (available from the publication section of the SEC) and assumes the most detailed filing (Form S-1) is to be used. Disclosures or descriptions that must be provided include

— Audited balance sheets for two years and statements of income and changes in financial position for three years.

— Description of the business, its markets, sources of supply, and its competitive conditions.

— A plan of operations.

— A statement of whether it will be necessary to raise additional funds within six months.

— Use of the proceeds of the present offering.

— Plan of distribution, including names of selling security-holders and information about the underwriters.

— Revenue, operating income or loss, and identifiable assets attributable to different industry segments.

— Nature of dependence on a few customers.

— Amounts spent on research and development.

— Segment information by geographic area.

— Descriptions of properties.

— Legal proceedings.

— History of market prices and dividends for most recent two years.

— Number of holders of each class of equity securities.

— Description of securities to be registered.

— Selected financial data for the last five fiscal years.

— Selected quarterly financial data.

— Management's discussion and analysis of financial condition and results of operations.

— Disagreements with and changes in public accountants.

— Identification of directors, executive officers, significant employees and their business experience, and involvement in bankruptcy and certain other legal proceedings.

— Executive compensation, stock options, and bonuses.

— Ownership by any group of more than 5 percent of any securities.

— Transactions with or indebtedness exceeding $60,000 with directors, executive officers, and other related or selected persons.

4.5 Exemptions From Registration

Numerous provisions eliminate, modify, or reduce the full registration filings otherwise required; a choice of exemptions may also be available. In some cases exemption applies to the securities to be issued, in other cases to a particular transaction, type of transaction, or type of buyer to whom the distribution will be targeted. Generally, a transaction exemption conveys no exemption from the registration procedures that might be required in the case of subsequent nonexempt resale of the same securities. The choice of exemption must be integrated with the marketing plan for distribution of the securities. The ramifications of state law must be considered. The choice of exemptions under which to qualify will be made by the underwriter and legal counsel experienced in securities laws.

Regulation D consolidates several *limited offering exemptions* and encompasses Rules 501 through 506. The first two of these define common terms and set out general conditions. Rule 503 describes the Form D filing that is required. The final three Rules describe the exemptions. The following are general conditions that govern circumstances for all Regulation D exemptions:

— Attempted compliance with a rule does not create an exclusive election, and other exemptions may be asserted.

— Compliance with a rule creates no exemption from other federal securities provisions, such as antifraud and civil liabilities, or from blue sky laws.

— The exemptions apply only to transactions by the issuer of the securities, not to the securities themselves or to resales, except that resales may be made for Rule 504 securities registered under blue sky laws.

Practitioners should be alert to advise their clients that exempt transactions and issues of exempt securities are still subject to state antifraud and blue sky laws as well as to the antifraud portions of federal securities law whenever the telephone, mail, or other instrumentalities of interstate commerce are used to offer, sell, or buy securities. The relevant portions of federal regulation are Section 10b of the 1934 act and SEC Rule 10b-5, which discuss the most commonly encountered exemptions.

OVERVIEW OF EXEMPTIONS UNDER REGULATION D

	Rule		
	504	505	506
Maximum size of offering	$500,000[4]	$5 million	No limit
General solicitation and advertising OK?	Yes[1]	No	No
Disclosure document required?	No	Yes[2]	Yes[2]
Maximum number of nonaccredited purchasers	No limit	35	35[3]
Restrictions on immediate resale?	No[1]	Yes	Yes
Form D filing required?	Yes	Yes	Yes
Related 1933 act section	3(b)	3(b)	4(2)

[1]As long as sales are made exclusively in state(s) requiring registration and delivery of a state-mandated disclosure document.
[2]Unless sales are made exclusively to accredited investors.
[3]Must be sophisticated investors.
[4]The limitation is increased to $1 million if the offering is registered under a state blue sky law.

4.5.1 Accredited investors

Various provisions of securities regulation confer special status and treatment for potential purchasers of securities who are designated "accredited investors." For example, accredited investors do not have to be counted when determining the thirty-five-purchaser limitation referred to in Rules 505 and 506. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions under Rules 505 and 506 and Section 4(6). These institutional investors are

— Banks (including those acting as fiduciaries).
— Investment companies.
— Insurance companies.
— Small business investment companies.
— Practically all employee-benefit plans subject to Title I of ERISA.
— Tax-exempt organizations having assets exceeding $5 million.
— Savings and loan associations supervised by a state or federal authority.

— Broker-dealers registered with the SEC under the 1934 Act.
— Corporations, partnerships, or business trusts with total assets exceeding $5 million, provided the entity has not been formed solely for the purchase.
— Trusts, other than business trusts, with assets that exceed $5 million and that are directed by a "sophisticated" person.

These are also considered accredited investors:

— Directors, general partners, or executive officers of the issuer
— Natural (not corporate) persons whose net worth, individually or jointly with a spouse, exceeds $1 million or whose annual income exceeds $200,000 (individually) or $300,000 (jointly)

The Small Business Investment Incentive Act of 1980 added Section 4(6) to the 1933 act to provide exemption from registration for transactions involving offers or sales solely to accredited investors if the offering price does not exceed $5 million and there is no advertising or public solicitation. A single offer or sale to a nonaccredited investor will invalidate this exemption. Form D must be filed. This exemption appears to be equivalent to SEC Rule 506.

4.5.2 Intrastate offerings

For this exemption to apply, the issuer and all offerees (and purchasers) of the exempted securities must be residents of the same state. In the case of a corporate issuer, both its principal place of business and its incorporation must be in the state. For offerees who are noncorporate business entities, only their principal place of business need be located in the state; for individuals, their principal residence. SEC Rule 147 requires that 80 percent of the proceeds be used in the state. The exemption is lost if a resale to a nonresident takes place within nine months after the last sale made in the same state.

4.5.3 Judicially approved exchanges

A relatively narrow exemption from registration is available under the 1933 act, Section 3(a)(10) when a judicial or federal or state administrative authority approves, as for example in a reorganization. This exemption has been used for court-approved settlements of private litigation.

4.5.4 Private placements

Section 4(2) of the 1933 act exempts transactions when there is no public offering (that is, no general solicitation). Offerings relying on this exemption will be made to sophisticated institutional and private investors who have access to the kind of information that would otherwise have to be provided in the registration documents. Since the statute itself does not identify what would constitute a nonpublic offering, the benefits of this section are of less certain operation than exemption under Rule 506, which is somewhat similar in its intent. For example, resale within a short period of time of the securities that were the subject of a private placement may cause the seller to be deemed an underwriter and may relate back and destroy the private placement exemption. The SEC's Rule 144 operates to provide protection against these unintended consequences. (See section 4.6, below.)

4.5.5 Rule 506

Characteristics of the securities offerings under Rule 506 include these:

— No limit on size of offering

— No limit on sales to accredited investors

— Sales to no more than thirty-five sophisticated investors

— Prohibition against solicitation to the general public

— Requirement of certain disclosures, unless all sales are made to the accredited investors

— Form D filing with the SEC

The sophisticated investors must be of sufficient business and investment acumen to be capable of evaluating the rewards and risks of the investments. In this task they may utilize the assistance of a personal financial adviser or a purchaser representative. Prior to sale of the securities, a disclosure document must be delivered to the prospective purchaser. Rule 506 provides a safe harbor for offerings that satisfy its requirements. Despite failure to qualify under some provision of Rule 506, an exemption under a similar provision, for example Section 4(2) concerning private placements, may still be available.

4.5.6 Small issues

To facilitate access to the capital markets by small businesses, several avenues are available to the small issuer or to the issuer of small amounts of securities. In addition to the rules discussed below, see the sections in this chapter that cover accredited investors, intrastate offerings, private placements, and simplified registration.

Rule 504. The exemption under Rule 504 carries these conditions:

— Issuer cannot be an investment company or any company otherwise required to report to the SEC.

— Issue is limited to $500,000 offering and sale within a twelve-month period, unless the offering is registered under a state blue sky law, in which case the limitation is $1 million.

— General solicitation is permitted if made in states that require registration and delivery of a disclosure document.

(Text continued on page 173)

— Form D must be filed with the SEC.
— Disclosure document need not be distributed if no general solicitation is made, unless required by state law.

Rule 505. The conditions for a Rule 505 exemption are

— Limitation to $5 million in a twelve-month period.
— No restrictions on number of offerees to which offering can be made so long as there is no general solicitation or advertising.
— Purchasers limited to thirty-five except for accredited investors.
— No limit to the number of purchasers who are accredited investors.
— If any sale is made to a nonaccredited investor, disclosure documents must be provided to all purchasers.
— Not available to issuers who are investment companies or to those guilty of postal or securities fraud.
— Form D must be filed with the SEC.

Since the thirty-five nonaccredited investors have to meet no particular standards for sophistication or suitability, this exemption is popular for limited partnerships. Unless formed for the specific purpose of acquiring the offered securities, an entity such as a corporation or partnership counts as one purchaser.

4.5.7 Voluntary exchanges

When an issuer exchanges a new issue of securities exclusively with its existing security-holders, an exemption from registration is provided. Cash paid or received to effect an equivalency of value does not invalidate the exemption. This exemption is not available where

— Remuneration is paid for solicitation, promotion, or underwriting.
— The securities are exchanged in the course of a Bankruptcy Act proceeding.

Technically, such exchanges are exempt transactions (rather than exempt securities). Subsequent resales of these securities by a holder will thus require registration unless shielded by another exemption.

4.5.8 Other exemptions

Exemptions are also available under Section 3(a) of the 1933 act for securities of the following:

— Federal, state, and local governmental bodies and organizations (including certain industrial development bonds)

— Federal Reserve banks
— Certain insurance companies
— Qualified pension, profit, and stock plans and certain Keogh partnership plans
— Notes, drafts, and bankers' acceptances with an original maturity of not more than nine months
— Building and loan associations
— Farmers cooperatives
— Bankruptcy act certificates
— Many insurance and annuity contracts

These are not blanket exemptions, however, and the securities acts, SEC rules, and court cases may bear on a particular offering. In some cases only an experienced securities attorney can be relied upon for confirmation of the exemption. The Keogh exemption, for example, is available only to firms offering services in the investment banking, pension consulting, investment advising, legal, and accounting fields. In these fields an employer can be expected to have the requisite knowledge and experience to guard his or her own as well as employees' interests. Independent investment advice must nevertheless be secured in setting up the plan.

4.6 Secondary Transactions and Rule 144

Section 4(1) of the 1933 act exempts from registration transactions by "any person other than an issuer, underwriter, or dealer." The term *issuer* includes any person who directly or indirectly controls or is controlled by the issuer. *Underwriter* means any person who purchases from an issuer "with a view to, or offers or sells for an issuer in connection with, the distribution of any security." Thus nonissuers and nonunderwriters can distribute securities in transactions deemed exempt under this section.

Advisers should warn their clients that institutions or individuals who purchase securities in exempt transactions and then resell the securities can unintentionally become underwriters. This outcome can ordinarily be avoided by adherence to Rule 144, which provides an exemption from registration for certain transactions. The purpose of the rule is to permit the public sale of limited quantities of securities—without prior registration—by affiliated persons and by persons who bought restricted stock from the issuer. (An affiliate is a person controlling, controlled by, or under common control of the issuer.) Six conditions are required for an exempt transaction under SEC Rule 144:

1. *Adequate public information.* This condition is ordinarily satisfied if the issuer is a reporting company under the 1934 act.
2. *Holding period.* The securities must have been beneficially owned and fully paid for by the seller for at least two years prior to this sale.
3. *Limited amount.* In any three-month period, the amount of securities sold is limited to the greater of (a) 1 percent of the outstanding shares or (b) the average weekly reported volume of trading.
4. *Manner of sale.* Sales must be made in "brokers' transactions" or in transactions with a market maker. (Brokers' transactions are those in which the broker executes orders while acting as the seller's agent.)
5. *Notice of offering.* In any three-month period, if more than 500 shares, or $10,000 of sales price will be offered, the seller must file with the SEC a notice on Form 144.
6. *Intent to sell.* The person filing the notice on Form 144 must have a bona fide intention to sell within a reasonable time.

If the sale is made by a nonaffiliated person who has been a beneficial holder for three years, the conditions regarding amount, manner of sale, and notice are waived. Sales on behalf of a controlling person, however, can cause the seller to be deemed an underwriter, thus canceling the exemption. Rule 405 defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." This undoubtedly confers "controlling person" status on top-level management of a corporation even if their stock ownership is minimal. The two-year holding period referred to in Rule 144 does not create a safe harbor for a controlling person.

Considerable litigation has resulted regarding Rule 144, and at least one book of substantial length has been devoted entirely to it. Because of varying judicial interpretation, clients must be advised not to place their reliance for an exemption entirely upon the two-year holding period, particularly if they are controlling persons within the context of the SEC rules. If the exemption of a resale transaction is challenged by the SEC, it is a question of fact to be decided by the courts whether a seller of securities originally purchased them with the intent to distribute them. Despite these possible pitfalls, however, most registered broker-dealers will have worked out procedures for safely handling Rule 144 securities and clients may be counseled to rely on these procedures.

4.7 Simplified Registration

Two methods of abbreviated registration are available. Form S-18 allows access to the capital markets by firms not required otherwise to report to the SEC without immediately incurring the full range of disclosure normally required. The salient aspects of a Form S-18 distribution are

— An aggregate offering price may not exceed $7.5 million.

— Proceeds may be in the form of cash, installments for cash, or by assumptions of debt.

— It may be used by corporate or noncorporate issuers.

— Requires one year's audited balance sheet plus statements of income and of changes in financial conditions for the two most recent fiscal years.

— The registrant must not be required to report to the SEC under the 1934 act.

— Filing may be made at a regional SEC office (perhaps achieving faster and less costly service).

— Public advertising and solicitation are allowed.

— Sales may be made for the account of a person other than the registrant (for instance, in a secondary distribution) for an amount not to exceed $1.5 million.

— It is not available for issuers that are investment companies or for most insurance companies.

Regulation A provides another type of simplified registration—in effect, a miniregistration. Its features are these:

— It allows aggregate offerings to $1.5 million by the issuer, its affiliates that became such within the last two years, and its predecessors. Additionally, included in the $1.5 million limitation are certain secondary distributions by affiliates and other exempt securities sold under Section 3(b) of the 1933 act (Rule 504 or 505).

— It provides for lower limits for securities offered on behalf of nonaffiliated persons other than the issuer. These are
  $100,000 on behalf of any person; $300,000 for all such persons.
  $500,000 limit if offering person is an estate.

— An offering statement (an abbreviated registration document) must be filed with the SEC.

— Filings are made with and reviewed by regional SEC offices.

— State registration will ordinarily be required.

— Financial statements need not be certified but must conform to generally accepted accounting principles.
— Financial statements must include a balance sheet prepared within ninety days of the filing and profit and loss statements for the two preceding fiscal years.
— Financial statement specifications to be found in SEC Form 1-A.
— An offering circular must be provided to prospective purchasers.

Many practitioners believe the costs of filing and the necessity for approval by the SEC, when compared to the small size of the allowed offering, argue against the use of Regulation A registration in cases where an exemption can be found within Regulation D.

5. THE SECURITIES EXCHANGE ACT OF 1934

5.1 Overview

The Securities Exchange Act of 1934, cited hereafter as the 1934 act, prescribes registration and reporting requirements for issuers of certain securities, by securities dealers, securities exchanges, and self-regulatory organizations (the only one to date being the National Association of Securities Dealers). The act in addition concerns itself with proxy solicitation, tender offers, insider profits, and manipulative and fraudulent practices. The 1934 act established the SEC.

5.2 Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934 to administer and enforce the securities acts, and therefore has extensive rule-making authority. Documents required to be filed by the securities acts are filed with the SEC. Mail can be addressed to the Securities and Exchange Commission, Washington, D.C. 20549, to make a request from its Publications Section. The main telephone number is (202) 272-3100. The Office of Consumer Affairs and Information Services can be reached at (202) 272-7440. Additionally, these phone numbers within the Division of Corporation Finance have proved particularly helpful:

Office of Chief Accountant (202) 272-2553
Office of Chief Counsel (202) 272-2573
Office of Small Business (202) 272-2644

Regional offices of the SEC initiate investigations and enforcement proceedings and can be queried for informal advice about matters of securities regulation. The regional offices and their phone numbers are:

New York, New Jersey	(212) 264-1614
Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire, Maine	(617) 223-2721
Tennessee, North Carolina, South Carolina, Georgia, Alabama,	(404) 881-4768

(Text continued on page 179)

Mississippi, Florida, Puerto Rico, Virgin Islands, Louisiana (east of the Atchafalaya River)	
Minnesota, Wisconsin, Iowa, Illinois, Missouri, Ohio, Michigan, Indiana, Kentucky, Kansas City, Kansas	(312) 353-7390
Oklahoma, Arkansas, Texas, Kansas (except Kansas City), Louisiana (west of the Atchafalaya River)	(817) 334-3821
Wyoming, Utah, Colorado, New Mexico, Nebraska, North Dakota, South Dakota	(303) 844-2071
California, Nevada, Arizona, Hawaii, Guam	(213) 468-3098
Washington, Oregon, Idaho, Montana, Alaska	(206) 442-7990
Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia	(215) 597-3100

5.3 Registration of Brokers and Exchanges

The SEC oversees operation of the two national stock exchanges, the New York Stock Exchange and the American Stock Exchange, as well as the eight regional exchanges. (Some stocks are traded both on a national and a regional exchange.) The regional exchanges are these:

Boston Stock Exchange
Chicago Board Options Exchange
Cincinnati Stock Exchange
Inter Mountain Exchange
Midwest Stock Exchange
Pacific Stock Exchange
Philadelphia Stock Exchange
Spokane Stock Exchange

The largest number of stock issues are not listed for trading on an exchange but are traded over-the-counter—in direct exchange between brokers. The National Association of Securities Dealers Automated Quotation System (NASDAQ) facilitates such trades. Possible advantages of listing on an exchange include

— Exemption from registration under some state blue sky laws.
— Increased attention from securities analysts, which increases investors' interest.
— Increased visibility and prestige in the business community.
— Price stability of shares because of readily available market quotations.
— Greater acceptance of shares as collateral by lending institutions.

Disadvantages include

— Necessity for providing more information to the SEC, the stock exchange, and shareholders.
— Initiation fees and annual charges.
— Restrictions imposed by the exchange.

5.4 Registration of Securities: General Issues

All securities traded on a national exchange must be registered with the SEC. The SEC may suspend trading in any improperly registered security. Over-the-counter securities must also be registered by issuers who have a class of equity securities with 500 or more shareholders and more than $3 million in total assets. The data required are similar to those required for securities act registration; recent SEC policy has been to bring the two registration procedures into closer agreement. Following registration, reports must be filed to keep the information up-to-date. This information is available for inspection at the Washington office of the SEC. SEC filings are also available, for a fee, from Disclosure, Inc., reachable at (800) 638-8241. Exemptions from exchange act registration are provided for the security issues of savings and loan, not-for-profit, and cooperative associations, certain insurance companies, and certain employee stock bonus, pension, or profit-sharing plans.

The process of registration is being facilitated through a newly developing system called *integrated disclosure.* Integrated disclosure is designed to reduce the incidence of duplicative and overlapping filings required by the various securities acts. Registration statements and prospectuses will still be required to provide transaction-specific information (unless an exemption is available) for the issuance of securities. Information focusing on the registrant/issuer, however, will in most cases already be available under the periodic and continuous reporting requirements of the 1934 act (through such Forms as 10-K, 10-Q, and 8-K).

The workings of the integrated disclosure system can be observed in the alternative use of these three different registration forms:

1. Form S-1 requires the most detail and is used by first-time registrants.
2. Form S-2 demands less detail and is available for use by issuers who have reported for three or more years under the 1934 act.
3. Form S-3, exacting the least detail, is available for issuers meeting the same three-year test as for Form S-2 but also requires as a precondition a "market following" test that assures the securities are widely held.

If a registrant qualifies for S-3 registration, no registrant-specific information is required. Instead, data about the registrant/issuer are incorporated by reference in other exchange act filings (such as 10-Ks, for example).

5.5 Registration of Over-the-Counter Securities: Specifics

Section 12(g) of the 1934 act, together with SEC Rule 12g, requires registration of the equity securities of issuers engaged in interstate commerce or in a business affecting interstate commerce or whose securities are traded by use of the mails or any means or instrumentality, if the issuer has total assets exceeding $3 million and there are 500 or more shareholders of the equity securities. Equity securities are

— Stocks or similar securities or securities convertible into stocks or similar securities.

— Any security carrying a warrant or right to purchase a stock or similar security.

— Certificate of interest or participation in a profit-sharing agreement.

— Preorganization certificate or subscription.

— Transferable share.

— Voting-trust certificate or certificate of deposit for an equity security.

— Limited partnership interest.

— Interest in a joint venture.

— Certificate of interest in a business trust.

— Any put, call, straddle, or other option or privilege of buying or selling a security to another.

For the purposes of this section, a class includes all securities of substantially similar character and those whose holders enjoy substantially similar rights. Thus common and preferred shares are not members of the same class, but common shares designated Class A and Class B might be, depending on the similarities of the rights of their holders. As to the existence of 500 shareholders, the SEC normally accepts the issuer's records on this point, even to accepting a corporation, a partnership, or street name as one holder.

Total assets are determined after deducting such allowances as those for depreciation, depletion, and bad debts. To temporarily postpone registration by staying below the threshold for registration, these techniques might be employed (after first considering their income tax consequences):

— Pay off liabilities with available assets.

— Pay dividends or purchase treasury stock from shareholders.

— Increase allowance accounts if possible to do so while maintaining conformity with generally accepted accounting principles.

— Spin off assets to shareholders.

— Any other tactic reducing assets or number of shareholders below the threshold levels.

The asset and shareholder tests are determined at the end of the company's fiscal year. This allows some maneuvering space for a potential registrant who exceeds the threshold values during the year but desires to stave off registration. Continuing use of such tactics over several years, however, might stimulate the SEC to insist on registration.

Registration, if required, must become effective within 120 days following the fiscal-year end. Normally, a registration becomes effective sixty days after its filing, although the period may be shortened at the discretion of the SEC. Accountants whose clients are approaching the threshold at midyear should be warned they may have to register with the SEC. Projections of year-end data well in advance of year end—particularly regarding total assets and number of shareholders—can provide potential registrants time to plan their response to the 1934 act requirements.

6. OTHER FEDERAL SECURITIES-RELATED ACTS

6.1 Foreign Corrupt Practices Act of 1977

The accounting provisions of the Foreign Corrupt Practices Act specify that all securities issuers who report to the SEC are required under Section 13(b)(2) of this act to

(A) Make and keep books, records, and accounts, that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that:

(i) Transactions are executed in accordance with management's general or specific authorization;

(ii) Transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) Access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any difference.

6.2 Investment Advisers Act of 1940

This act, according to a 1981 SEC staff report, may require registration as an "investment adviser" by "financial planners" and others who provide investment advice to their clients for compensation. Three exceptions from registration are provided under the act:

1. *Intrastate exception.* Section 203(b)(1) provides an exception for an investment adviser whose clients are all residents of the state within which the adviser maintains the principal office and place of business, as long as he or she does not furnish advice or issue analyses or reports about securities listed or admitted to unlisted trading privileges on any national securities exchange. (There may still be certain state registration and reporting requirements.) An investment adviser is also subject to the act's antifraud provision. A person who is not an investment adviser (which includes the accountant's exception) is not subject to the act at all.
2. *Insurance company adviser.* This exception is for those advisers whose only clients are insurance companies. Section 203(b)(2) applies.
3. *Private investment advisers.* Section 203(b)(3) offers an exception for investment advisers who, during the course of the preceding twelve months, had fewer than fifteen clients and who neither hold themselves out generally to the public as investment advisers nor act as investment advisers to an investment company registered under the 1940 act or to a "business development company."

Public accountants may be required to register in certain circumstances. Persons or firms who engage for compensation in the business of advising others concerning securities transactions must register with the SEC. This includes advising directly or through publications or writings as to the value or advisability of purchasing or selling any security. Any "accountant whose performance of such services is solely incidental to the practice of his profession" is exempted (Section 202(a)(11). Any form of recommendation to a client concerning a specific security made by a public accountant potentially could cross the "solely incidental" threshold.

6.2.1 Consequences of registering

Certain activities follow upon registration under the Investment Advisers Act.

Reporting. Reporting is done on Form ADV, which requires the adviser to give information about various practice aspects:

— The nature of the business
— Background, education, and experience of the principals and employees
— Whether there are grounds for disqualification from registration
— Amount of assets under management
— Type of clients advised
— Kinds of investment advisory services provided
— Methods of securities analysis

An annual report, Form ADV-S, is required within ninety days after the close of the adviser's fiscal year.

Recordkeeping. Certain records are required of registered advisers and may be inspected by the SEC:

— Journals and ledger accounts
— Memoranda or orders and instructions for purchase, sale, receipt, or delivery of securities
— Copies of certain communications received or sent
— Listings and records relating to discretionary accounts
— Copies of all written agreements
— Copies of publications and recommendations distributed to ten or more persons and information indicating the factual basis for the recommendations
— Records of certain securities transactions entered into

Disclosure. The so-called "brochure rule" requires the adviser to furnish to prospective clients certain kinds of information. Generally, it is data of the sort included in Form ADV:

— Services provided

— Types of client served

— Methods of security analysis used by the adviser

— Standards of education and business background required of the adviser's principals and employees

— Descriptions of the specific backgrounds of its principals and employees

Performance fees. Although the act itself prohibits a registered investment adviser from receiving compensation based on a share of the capital appreciation in a client's account, under certain conditions this will be acceptable under a new SEC rule (SEC Investment Advisers Act Release No. 996 (November 14, 1985)).

Antifraud provisions. It is unlawful for an investment adviser to "employ any device, scheme, or artifice to defraud any client or prospective client" or to engage in any activity that operates as a fraud upon a client. Even persons excused from registration by one of the three exceptions from registration are subject to these antifraud provisions. Persons who rely on the exceptions from the definition of investment adviser, including the accountant's exception, however, are not subject to these provisions.

6.2.2 Examples of situations involving public accountants

The following cases are based on examples presented in the book, available from the American Institute of Certified Public Accountants, titled Personal Financial Planning Practice Aid No. 1: *Issues Involving Registration Under the Investment Advisers Act of 1940*:

> **Case 1.** John is a CPA with an active practice. He spends most of his time preparing and reviewing tax returns and in analyzing the tax consequences of proposed transactions for his clients. From time to time, in preparing a tax return for a particular client, John suggests the client might consider tax shelter, tax-exempt bonds, or mutual funds . . . . John will be able to rely on the accountant's exception. He will not be required to register as an investment adviser because he meets the "solely incidental" test as stated by SEC staff. His exemption arises because
>
> He is not holding himself out as an investment adviser.
>
> The investment services he is rendering appear to be related to the accounting services he provides.

He appears not to be charging a special fee for his advisory services.

Case 2. After three years with a local firm, Margaret starts her own practice. She intends to advertise "planning services" as a special service available in her accounting practice. She hopes financial planning will be the major emphasis of her practice. Margaret will do comprehensive financial planning for a fee, will give opinions on, and recommend, specific investment vehicles, IRA plans, tax shelters, and pension arrangements . . . . Margaret cannot rely on the act's accountant's exception, since she appears to be holding herself out as a financial planner who is providing investment advice.

Case 3. Fred, a CPA, holds himself out as providing personal financial planning services as well as accounting and tax services. Except in rare instances, the investment advice he provides is limited to discussing in general terms the role different sorts of investment vehicles might play in a client's overall investment plan. Although Fred is holding himself out as a financial planner, the kind of advice he is providing appears not to be of the type that would cause him to meet the definition of investment adviser. (*Warning*: The SEC staff, however, might take a contrary position if confronted with these facts.)

Case 4. Banners and Croft, CPAs, is a medium-size firm that recently established a financial planning team. The team follows a four-step approach:

1. Presenting seminars addressing goal setting, money management, tax and estate planning, insurance, and investments.
2. Collecting data from clients about their assets, liabilities, and cash flows.
3. Using computer software to project net worth, tax liability, and cash flow for several investment alternatives.
4. Reviewing annually each client's financial plan to judge whether progress is being made toward his or her goals and whether the goals should be adjusted.

Banners and Croft does not act as sales agent for any investment vehicles. Once a client indicates an interest in a particular vehicle—municipal bonds or equities, for example—the firm provides a list of local advisers and brokers who are rated by a national rating service. The issue is whether establishment of the team constitutes holding oneself out as being in the financial planning business because financial advising is not solely incidental to the firm's accounting practice (and therefore not covered by the accountant's exception). Even if the financial planning business is not covered by the accountant's exception, the firm would not need to register under the act so long as the business did not result in meeting the definition of investment adviser. The firm does not meet this definition, since

- — The securities advice is general and focused on the role of securities in a client's overall plan.
- — Advice is not directed toward specific securities

6.3 Investment Company Act of 1940

An investment company is one engaged primarily in the business of investing, reinvesting, or trading in securities. The most commonly encountered example of an investment company is a mutual fund. The 1940 act requires registration of investment companies and spells out such safeguards over operations as ratification by shareholders of the selection of the independent public accountant and changes in investment policy. Unexpected consequences may derive from operation of the act: for example, an investment company that fails in its duty to register will find itself denied access to the courts if it should attempt to enforce a contract with another party. The act contains provisions for the independence of the boards of directors and for separate investment advisers. Criminal penalties are set out for willful violations of the act. There are also antifraud provisions and private remedies, both of which supplement similar provisions in the 1933 and 1934 acts, which are also operative regarding investment companies.

6.4 Trust Indenture Act of 1939

The Trust Indenture Act of 1939 provides that evidences of indebtedness such as bonds may not be offered to the public unless they are issued under an agreement (called a trust indenture) that has been passed on by the SEC. Among its other provisions, this act specifies the requirements for persons who serve as trustees for the bondholders. Accountants ordinarily have no direct role in the preparation of the registration documents or the annual filings required under this act. It may be desirable, however, for the issuing debtor's public accountant to review the trust indenture to provide advice concerning covenants that impact the financial statements or operations of the issuer.

6.5 Public Utility Holding Company Act of 1935

The Public Utility Holding Company Act of 1935 requires registration of holding companies operating electric utility or retail gas businesses. Financial statements required with the registration documents and with annual reports to the SEC must be audited by independent public accountants.

6.6 Racketeer Influenced and Corrupt Organizations Act (RICO)

The Racketeer Influenced and Corrupt Organizations Act was promulgated as part of the Organized Crime Control Act of 1970 to protect businesses against organized crime. RICO has been used against legitimate businesses such as brokers, banks and investment bankers, lawyers, insurance companies, manufacturers, and public accountants.

RICO makes it illegal to

- Use income derived directly or indirectly from a pattern of racketeering activity to acquire any interest in an enterprise.
- Acquire any interest in or control of an enterprise through a pattern of racketeering activity.
- Conduct or participate, directly or indirectly, in the affairs of an enterprise through a pattern of racketeering activity.
- Conspire to violate any of the above provisions.

A wide variety of conduct can constitute racketeering under this statute, including murder, arson, bribery, embezzlement, mail and wire fraud, securities fraud, and pornography and drug dealing. Mail fraud is a particularly broad offense, having as its essential elements the mailing of a letter while motivated by a deceitful thought. The act allows a private legal action by "any person injured in his business or property" by conduct that is punishable as a crime. Access to court is granted the injured party upon his or her allegation that the defendant committed the illegal conduct; no prior conviction need be shown. When a civil rather than a criminal remedy is sought, as for example by an investor against a stockbrokerage firm, the civil standard of proof by a preponderance of evidence is required. This is a less rigorous standard of proof than that required in a criminal case, where the standard is proof beyond a reasonable doubt. To the successful plaintiff in a civil action, recovery of treble damages may be allowed together with costs of the suit, including attorneys' fees. Numerous states have enacted their own RICO statutes. Because RICO has been used as an entree to court against legitimate businesses, including public accountants, both the American Institute of Certified Public Accountants (AICPA) and the National Advisory Council to the Senate's Small Business Committee have urged that RICO be amended to require plaintiffs to show the defendant has been convicted of a prior criminal racketeering activity.

6.6.1 State RICO statutes

Simultaneous RICO litigation under the federal statute and one or more state statutes is possible. The federal statute clearly spells this out:

> Nothing in this title shall supersede any provision of Federal, State, or other law imposing criminal penalties or affording civil remedies in addition to those provided for in this title.

A growing number of states have enacted RICO clones. These statutes mimic to a greater or lesser extent the federal statute. The provisions of these various state acts are shown in table I (on the next page).

Twenty state RICO statutes specifically include fraud in the purchase or sale of securities as a racketeering act. Ten identify mail or wire fraud as predicate acts. These instrumentalities of interstate commerce are beyond the scope of state regulation. However, the states that identify these types of fraud as racketeering acts do so by reference to the federal statute, making the federal racketeering acts state racketeering acts as well.

Of the twenty state RICO laws that include securities fraud or mail and wire fraud as predicate acts, seventeen allow private remedy. Six of these jurisdictions provide for punitive damages in addition to damages for the injury (treble or double) and the recovery of court costs and reasonable attorney's fees. This is a civil remedy that is more liberal than that provided under the federal statute. (Federal RICO allows only treble damages plus court costs and reasonable attorney's fees.) Eight of the remaining eleven jurisdictions provide a measure of damages that is equivalent to damages allowed under federal law.

Although state statutes tend to reflect or expand on the federal measure of damages, they also frequently limit the applicability of RICO. Of the twenty-eight jurisdictions with RICO clones, three states (Illinois, Louisiana, and Tennessee) limit predicate acts to narcotics law violations. Six jurisdictions limit the application of RICO by not allowing private suits. In order to initiate a private RICO action under Delaware law, the defendant must have a previous criminal conviction for a racketeering act that was the source of the plaintiff's injury (action must be brought within one year of the defendant's conviction). North Carolina and Ohio require that in a private RICO action alleging securities fraud, one of the pattern acts must be an act other than fraud in the sale of securities. In a private RICO action alleging securities fraud under the Washington statute, the defendant must have been previously convicted on a criminal charge of securities fraud. Conviction for the pattern acts themselves is not required.

Fifteen jurisdictions have included in their definition of the pattern of acts the requirement that the predicate acts have the same (or similar) purposes, results, participants, victims, methods of commission, or be otherwise interrelated by distinguishing characteristics and not simply isolated events. Thus, these states have included in their statutes the continuity and relationship standard which, as result of the *Sedima* (FPRL

TABLE I. STATE RICO STATUTES

State	Private Remedy	Pattern of Acts			"Racketeering Acts" Include		Damages		
		No. of Acts	Similar Not Isolated Acts	Maximum Time Allowable Between Pattern Acts	Fraud in Purchase/ Sale of Securities	Mail or Wire Fraud	Treble	Punitive	Costs + Fees
AZ	Yes	1	N/A	N/A	Yes	No	Yes	No	Yes
CA	No	2	Yes	last/10 yrs. of 1st	Yes	No	N/A	N/A	N/A
CO	Yes	2	No	last/10 yrs. of 1st	Yes	Yes	Yes	No	Yes
CT	No	2	Yes	last/5 yrs. of 1st	Yes	No	N/A	N/A	N/A
DE	Yes[1]	2	No	last/10 yrs. of 1st	Yes	Yes	Yes	Yes	Yes
FL	Yes	2	Yes	last/5 yrs. of 1st	Yes	Yes	No[2]	No	No
GA	Yes	2	Yes	last/4 yrs. of 1st	Yes	Yes	Yes	Yes	Yes
HI	Yes	1	N/A	N/A	No[3]	No	No[2]	No	Yes
ID	Yes	2	Yes	last/5 yrs. of 1st	Yes	No	Yes	No	Yes
IL	Yes	2	No	last/5 yrs. of 1st	No[4]	No[4]	Yes	No	Yes
IN	Yes	2	Yes	last/5 yrs. of 1st	Yes	No	Yes	Yes	Yes
LA	Yes	2	Yes	last/5 yrs. of 1st	No[4]	No[4]	Yes[5]	No	Yes
MS	Yes	2	Yes	last/5 yrs. of 1st	Yes	No	Yes	Yes	Yes
NV	Yes	2	Yes	last/5 yrs. of 1st	No[3]	No	Yes	No	Yes
NJ	Yes	2	Yes	last/10 yrs. of 1st	Yes	Yes	Yes	No	Yes
NM	Yes	2	No	last/5 yrs. of 1st	Yes	No	Yes	No	Yes
NY	No	3	No[6]	last/10 yrs. of 1st	Yes	No	N/A	N/A	N/A

NC	Yes	2	Yes	last/4 yrs. of 1st	Yes[7]	Yes	Yes	No	Yes
ND	Yes	1	N/A	N/A	Yes	No	Yes	No	Yes
OH	Yes	2	No[6]	last/6 yrs. of 1st	Yes[7]	Yes	Yes	No	Yes
OR	Yes	2	Yes	last/5 yrs. of 1st	Yes	Yes	Yes	Yes	Yes
PA	No	2	No	no limitation	No	No	N/A	N/A	N/A
PR	No	1	N/A	N/A	No[3]	No[3]	N/A	N/A	N/A
RI	Yes	1	N/A	N/A	No	No	Yes	No	Yes
TN	No	2	Yes	last/2 yrs. of 1st	No[4]	No[4]	N/A	N/A	N/A
UT	Yes	3	Yes	last/5 yrs. of 1st	Yes	Yes	No[8]	No	Yes
WA	Yes	3	Yes	last/5 yrs. of 1st	Yes[9]	No	No[2]	No	Yes
WI	Yes	3	No[6]	last/7 yrs. of 1st	Yes	Yes	No[8]	Yes	Yes

[1]In order to initiate a private RICO action under Delaware law, the defendant must have a previous criminal conviction for a racketeering act that was the source of the plaintiff's injury. Action must be brought by the plaintiff within one year of the defendant's conviction.

[2]Florida, Hawaii, and Washington limit damages to the actual loss incurred. However, Washington courts, at their discretion, may impose treble damages.

[3]Not directly defined as a racketeering activity. Under Hawaii's statute, racketeering activities include "any act . . . chargeable as a crime under state law and punishable by imprisonment for more than one year." Nevada's statute includes within the definition of racketeering acts, "obtaining possession of money or property valued at $100 or more, or obtaining a signature by means of false pretenses." Under Puerto Rico's statute, racketeering acts include, "any act . . . subject to criminal arraignment under the laws of the Commonwealth of Puerto Rico, or the laws of the United States of America."

[4]*Racketeering Acts* are limited to violations of narcotics laws.

[5]Or $10,000, whichever is greater.

[6]New York and Ohio require only that the pattern acts not be isolated. Wisconsin requires only the acts to be similar.

[7]North Carolina and Ohio require that one of the pattern acts must be an act other than fraud in the sale of securities.

[8]Utah and Wisconsin limit damages to twice the actual loss incurred.

[9]In a private RICO action alleging securities fraud, the defendant must have been previously convicted on a criminal charge of securities fraud (conviction for the pattern acts themselves is not required).

SOURCE: Analysis by R. Welton, G. Friedlob, C. Dungan.

v. Imrex Co., 105 S. Ct. 3275) decision is now being applied in federal cases. The effect of this standard is to limit prosecution to offenders engaging in repeated criminal activity. States requiring similar, not isolated acts are identified in table I.

Another method of limiting the application of RICO is to adopt a narrower time limitation between the commission of the pattern acts. Under the federal statute, a pattern of racketeering acts is established if the time between the predicate acts does not exceed ten years. Seventeen states have adopted time limitations that are stricter than the federal limitation. The most common reduction is to require that the last pattern act occur within five years of the first. Four states require that a pattern consists of three or more racketeering acts, allowing prosecution only when criminal intent is demonstrated through repetition. The time limitation and the number of predicate acts required to establish a pattern under each state statute is shown in table I.

However, not all states have attempted to narrow the application of RICO. Five states have cast the net wider than the federal law by defining a *pattern of racketeering* as the commission of only one prohibited act (see table I).

6.7 Securities Investor Protection Act of 1970

The Securities Investor Protection Act of 1970 requires almost all broker-dealers to be members of the Securities Investor Protection Corporation (SIPC). Through assessments of its members to create a fund of $150 million, the possibility of levying a charge on stock exchange and over-the-counter transactions, and authority to borrow up to $1 billion from the U.S. Treasury, the SIPC can advance funds to satisfy claims by customers of failed broker-dealers. SIPC coverage extends to a maximum of $500,000 for each customer, but not more than $100,000 for claims for cash held by a failed broker.

Notification to the SIPC originates with the broker-dealer, the SEC, or a self-regulatory organization such as the National Association of Securities Dealers. Customers of an SIPC member in financial difficulty have no rights, by themselves, to require the SIPC to act. Customers who suspect they may be damaged by a broker-dealer's financial difficulties should contact an attorney or the SEC. Once the SIPC determines the financial status of a broker-dealer it may apply to the courts for customers' protection under the act. The court then appoints a trustee and an attorney for the trustee who go about returning specifically identifiable property to customers, completing any open contractual commitments of the firm, selling the assets of the firm, and paying off customers and other creditors. It is a process similar to that of Chapter 10 of the bankruptcy act.

6.8 Small Business Incentive Act of 1980

The thrust of the Small Business Incentive Act of 1980 is to exempt companies that elect to qualify as business development companies from certain burdensome provisions of the Investment Company Act of 1940. Business development companies provide assistance in the form of capital and managerial expertise to small businesses, both those that are financially sound and those that are trying to regain their liquidity. Sections 54 through 65 of the Investment Company Act provide the details of qualification. Accountants who need a detailed analysis of this act should refer to Reginald L. Thomas and Paul F. Roye, "Regulation of Business Development Companies," 55 S.Cal.L.Rev.895 (1981), an article that should be available through any law school library.

7. STATE SECURITIES REGULATION

Nearly all states register securities and broker-dealers. The wisest preliminary assumption, therefore, is that state registration will be required whenever securities are issued, although a majority allow for registration by coordination. In these states full registration may consist only of paying the fees, naming an agent, and filing with the state the same documents that are required at the federal level. When the federal registration becomes effective, so does the state's. States' antifraud statutes continue to be operative despite SEC registration (or exemption from registration). Additionally, most states' commissioners or administrators of securities (whatever the title) will retain power to suspend distribution in their states upon suspicion of fraud.

Despite the adoption of the Uniform Securities Act, or a portion of it, in a majority of states, considerable variation in detail still exists, particularly in the fifteen or so states that either have not adopted the act or have passed highly individualized versions of it. A few relatively common features can be cited. Except for the District of Columbia, all of the states and Puerto Rico require registration of securities in some circumstances. Securities already listed on the New York and American stock exchanges are exempt from further registration in most jurisdictions. Also, issuers of securities benefiting from a Regulation D exemption from SEC registration under Rule 505 or 506 will often find an equivalent exemption at the state level.

Although full enumeration of state variation would be impractical, and legal counsel must be consulted, the table in section 7.2 can be used to provide a preliminary assessment of the existence at the state level of a Regulation D exemption. The Uniform Limited Offering Exemption (ULOE) cited in the table represents a state administrator's rule, of increasing adoption, that offers a limited transaction exemption based on SEC Regulation D but with further restrictive conditions, subject to the discretion of the administrator. An annotated version of the relevant state statutes can be consulted for further detail. For comparative data on several states, refer to Commerce Clearing House's *Blue Sky Reporter*. Both sources can be found in law school libraries, lawyers' offices, county law libraries, and some public libraries.

7.1 Uniform Securities Act

The Uniform Securities Act was drafted as the result of a two-year study at Harvard Law School. It has been adopted, with minor variations, by all states, except these:

Arizona	Louisiana	Rhode Island
California	Maine	South Dakota
Florida	New York	Texas
Georgia	North Dakota	Vermont
Illinois	Ohio	

(Text continued on page 195)

Some of these states (California, Ohio, and Texas, for example) have adopted selected portions of the act. The act is divided into four parts.

Part I proscribes fraudulent practices in connection with the purchase or sale of securities and in connection with investment advisory activities. No exemptions are provided from the prohibitions against fraudulent practices.

Part II requires the registration of broker-dealers, investment advisers, and employees of securities issuers who act as agents for the issuer.

Part III requires registration, unless an exemption can be found, of issues of securities before they can be sold in the state. The process called registration by coordination allows the registration documents filed with the SEC, when also filed with the state, to fulfill the state's registration requirements. (This portion of the uniform act has been adopted by California, Texas, Ohio, and South Dakota, which otherwise have not adopted it.)

Part IV contains definitions and matters of general applicability.

7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

	Rule 504	Rule 505	Rule 506	ULOE*
ALABAMA		X	X	
ALASKA				X
ARIZONA		X	X	
ARKANSAS			X	
CALIFORNIA			X	
COLORADO[1,3]	X	X	X	
CONNECTICUT		X	X	
DELAWARE	X	X	X	
DISTRICT OF COLUMBIA[2]	X	X	X	
FLORIDA[3]		X[a]	X[ab]	
GEORGIA[3]		X	X	
HAWAII			X	
IDAHO		X	X	
ILLINOIS		X[a]	X[ab]	
INDIANA	X	X[ab]	X[a]	
IOWA		X	X	X[c]
KANSAS				
KENTUCKY		X	X	
LOUISIANA			X[b]	

Table 7.2 (*Continued*)

	Rule 504	Rule 505	Rule 506	ULOE*
MAINE			X	
MARYLAND		X	X	
MASSACHUSETTS				X[e]
MICHIGAN		X	X	X[c]
MINNESOTA		X	X[b]	X[c]
MISSISSIPPI		X[a]	X[ab]	
MISSOURI		X	X	
MONTANA		X	X	
NEBRASKA		X	X	
NEVADA[1,3]	X	X	X	
NEW HAMPSHIRE				X[d]
NEW JERSEY [1,3]	X	X	X	
NEW MEXICO				X[d]
NEW YORK[1,3]	X	X	X	
NORTH CAROLINA			X	
NORTH DAKOTA				X[e]
OHIO			X	
OKLAHOMA	X	X	X	
OREGON	X	X	X	
PENNSYLVANIA		X	X	X[c]
RHODE ISLAND				X[d]
SOUTH CAROLINA				X
SOUTH DAKOTA		X	X	X[ce]
TENNESSEE			X	X[c]
TEXAS			X	
UTAH		X	X	
VERMONT		X	X	
VIRGINIA		X	X	
WASHINGTON	X		X	
WEST VIRGINIA				X
WISCONSIN		X	X	
WYOMING				X

Sources of Data

Harold S. Bloomenthal, *Securities Law Handbook, 1986-1987 Edition*

Blue Sky Reporter Commerce Clearing House

[a]Similar exemption existed prior to Regulation D

[b]Variations apply in connection with accredited investors

[c]Modified ULOE to count purchasers rather than offerees

[d]Exemption for isolated transactions

[e]State filing is required

[1]Only intrastate offerings are regulated

[2]Does not register securities

[3]Full SEC regulation obviates state registration

*Uniform Limited Offering Exemption drafted by the North American Association of Securities Administrations.

8. ACCOUNTANTS' LIABILITY UNDER THE FEDERAL SECURITIES ACTS

This is a complex and evolving area, and this section merely suggests a few of the issues involved. An excellent treatment, directed to certified public accountants, may be found in the recent book by Denzill Causey listed in this chapter's references.

8.1 Securities Act of 1933

Two sections of the 1933 act deal with the independent public accountant's liability, Section 11 and Section 12. Section 11(a) provides that any person may sue "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement." To establish a case, the plaintiff must allege

— The financial statements were misleading because of a misstatement or omission.

— The misstatement or omission was material.

— The security was purchased within a time period during which the law presumes that purchase was made in reliance on the statements.

— A loss was suffered.

Legal action must be brought within one year after the error is or should have been discovered, but in no case outside a period beginning with the date of the offering and ending three years thereafter. Reliance on the statements is presumed: It is not necessary for the plaintiff to allege and prove reliance upon, or even that he or she saw, the financial statements. Among the several defenses that could be claimed by a public accountant, two are worth our discussion:

The statements are not untrue by a material amount.

The public accountant exercised due diligence.

Although materiality is a concept much discussed in accounting literature, in securities-related matters it effectively becomes a matter of fact within the context of each case. An SEC rule (12b-2) states that an item is material if "there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered." In *Escott* v *BarChris Construction Corp.*, 283 F. Supp. 643 (SDNY 1968), the court did not consider to be material an erroneous misstatement of earnings from $.65 to $.75 per share but did hold that an error in the current ratio, incorrectly inflating it from 1.6 to 1.9, was material. Although generalizations are difficult, it is probably safe to say that the threshold of materiality in a securities case will be low enough to allow the admission to court of a case that is not perceived by the court to be otherwise deficient or trivial.

The due-diligence defense provides that no person, other than the issuer, shall be liable who shall sustain the burden of proof that he or she had, "after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true . . . " (Section 11(b)(3)). The act goes on to say that the standard of reasonableness shall be that of a prudent man in the management of his or her own property. Liability under Section 11 extends to the effective date of the registration statement, so it behooves a public accountant to exercise due diligence by reviewing events until as close to this date as is practicable. In the appropriate circumstances resignation and disclaimer of all responsibility in writing to the issuer and to the SEC by the effective date should be sufficient to avoid liability.

A public accountant who audits financial statements to be included in a registration must assure that his or her engagement is performed and the work documented

— By persons having training and proficiency as public accountants and who work under adequate supervision.

— In accordance with generally accepted auditing standards (GAAS).

SEC-related cases in which public accountants have been held liable suggest that these areas should be given particular attention:

— Indications of less than complete candor on the part of management

— Any doubts whatsoever concerning management integrity

— Conflicting or unsatisfactory explanations for unusual transactions that have more than a trivial impact on the financial statements

— Nontypical patterns of sales particularly near year end, or typical patterns when economic or competitive conditions would predict the contrary

Malpractice problems seem often to arise not from failure to detect an improper transaction but rather from failure to properly interpret and disclose the meaning of the transaction once it has been found. The cure for this deficiency seems to lie

— In thorough and continuing training of professional staff.

— In provision and actualization of close liaison between the staff performing the engagement and top-level, SEC-experienced partners.

Additionally, of course, an insurance policy endorsed for SEC-related coverage is a must.

Section 12(2) imposes liability on any person who "offers or sells a security . . . by means of a prospectus or oral communication, that includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading."

In other contexts it has been held that any written offer constitutes a prospectus, so any writing and any oral communication could be the basis of a legal action. Presumably, unless they become sellers or offerors of securities, certified public accountants are not likely to be charged under this rule. Accountants, however, could be charged with aiding and abetting such a violation. The courts are split as to whether silence and inaction on the part of an accountant can lead to a charge of aiding and abetting. Within the last half-dozen years one court has stated there is no aiding nor abetting in the absence of knowledge by the accountant of a securities violation (for example, a misstatement in a financial statement) together with "substantial assistance" by the accountant (*IIT* v *Cornfeld,* 619 F.2d 909 (2d Cir. 1980)). On the other hand, another court held that silence and inaction were sufficient for the charge where the defendant accountant intended to further the fraud or had an independent duty to disclose the misbehavior (*Woodward* v *Metro Bank of Dallas,* 522 F.2d 84, 97 (5th Cir. 1975)).

8.2 Securities Exchange Act of 1934 and SEC Rule 10b-5

Section 10(b) of the 1934 act and the SEC's interpretation in Rule 10b-5 create grounds for legal action against public accountants. For our purposes the essence of the act and the rule may be stated as follows: In connection with the purchase or sale of any security, no person shall use any device to defraud; no person shall make any untrue statement of (or omit to state) a material fact; no person shall engage in any act that would operate as a fraud or deceit. Jurisdiction of the SEC through the act and rule is established if the mails or the telephone is used in any part of the scheme or if a check is cleared; thus, practically all securities transactions, including those that might appear to be intrastate and not subject to SEC jurisdiction, may be included. There is no requirement that any filing of any sort with the SEC be made or fail to have been made. Criminal actions can be brought by the Justice Department acting on the request of the SEC, or injured private parties may enter a civil suit to recover damages.

Considerable anxiety arose among certified public accountants when it appeared that the rule might be applied against them as a consequence of their "mere" negligence. This fear was mitigated when the Supreme Court held that a showing of scienter was required—that is, that the CPA had acted with the intent to make a misstatement or to defraud (*Ernst & Ernst* v *Hochfelder,* 425 U.S. 185 (1976)). The courts have not resolved whether conduct by a CPA that could be described as "reckless," although without guilty intent, would be sufficient to fulfill the requirement for scienter.

9. GOING PUBLIC

"Going public" means offering stock for sale to the public. The Securities Act of 1933 requires that a registration statement be filed with the SEC before a public offering of securities is made in interstate commerce or through the mails, unless the offering qualifies for an exemption. The registration statement is available to the public from the SEC. Somewhat similar requirements are imposed by the Securities Exchange Act of 1934 for certain companies—those seeking to have their securities listed and registered for public trading on an exchange and those whose equity securities are traded over the counter, having at least $3 million in assets and at least 500 shareholders.

9.1 Registration Statement

The registration statement is a document presented in narrative form, similar to a brochure. Registration serves to provide investors with a source of information and does not constitute approval of the investment by the SEC.

The registration statement does not become effective immediately upon its filing. No sales of securities may be made until it becomes effective, although expressions of interest can be solicited from investors by showing them a preliminary prospectus called a "red herring." Only the securities subjected to the filing process are considered registered; previously issued and outstanding securities must comply with SEC regulations before being resold.

A registration statement consists of two principal parts:

— A prospectus, or selling document, that must be furnished to all purchasers of the securities and

— A supplemental part containing information that will be available subsequently at the SEC or by mail upon request and the payment of a small fee.

Each of several forms tailored to the type of issuing company specifies the information required for registration. Form S-1 is the basic and most commonly used form for full registration of an initial public offering (IPO). Instructions for the financial statement portions of the forms are found in Regulation S-X. Regulation S-K gives instructions for the nonfinancial aspects of a registration. These regulations and forms are available from the publications section of the SEC. Registration statement requirements are discussed in sections 4.4, 5.4, and 5.5 of this chapter.

The company must provide whatever information is necessary to make the statement complete and not misleading. The SEC will not pass judgment on the value of the offering as an investment, but will frequently require amendments to the registration documents to improve disclosure.

9.2 Alternative Registration for Small Issues

Simplified registration on Form S-18 is available for securities to be sold to the public for cash at a price not exceeding $7.5 million, provided the issuer is not subject to the continuous reporting requirements of the Securities Exchange Act of 1934. The issuer must have its principal place of business in the United States or Canada. The requirements for simplified registration are set forth in section 4.7 of this chapter.

9.3 Selling Securities Without Registration

Exempt transactions relate to securities sales that are technically not public offerings in that they are private or otherwise limited. As with all securities sales, antifraud laws apply and disclosures made to investors must be truthful. Despite federal exemption from registration, a "notification" must be filed with the SEC, and state securities laws may similarly require a filing. Issuing securities without registration and under an exemption may not fulfill company goals in that subsequent sales of the securities will be restricted by SEC rules.

Section 4.5 of this chapter deals with conditional exemptions under SEC Regulation A, as well as with exemptions under Regulation A, SEC Rule 147, and Section 4(6) of the 1933 Securities Act.

9.4 State Securities Laws

The term "blue sky laws" refers to laws governing securities sales in each of the fifty states. In some states, an effective federal registration fulfills all state requirements. In others, the registration statement or other disclosure document must be submitted to the state commissioner of securities. Most states have a system of merit review through which offerings are scrutinized for compliance with criteria such as the size of the underwriters' commissions and fees. Most states require that sales reports be filed after the offering is complete since fees are based on sales within the state. State securities administrators can provide information. Section 7 of this chapter discusses state securities regulation.

9.5 Advantages and Disadvantages of Going Public

9.5.1 Advantages

A company's prestige and image are usually enhanced by public sale of stock. Often greater respect will be accorded to the company and its management by customers, competitors, and associates.

CEOs report that employee morale significantly increases. Going public is an immediate wealth-builder for present owners, who could see a hundred-fold increase in documented personal wealth. Establishing a market valuation on stock makes stock options a more attractive benefit to executives and managers and is a less costly incentive than salary increases. Enhanced liquidity rewards company founders with a market for their stock. Pledging publicly offered stock makes personal borrowing easier.

A growing company needs a strong source of capital. A higher price per share can be commanded in a public offering than in a venture capital arrangement or private placement because the promised rate of return can be lower. Alternatively, a necessary amount of capital can be raised with less ownership dilution.

Good market performance of stock issued now will make it easier to raise capital in the future. An IPO improves the debt-to-equity ratio; future borrowings can be made on more favorable terms. Finally, a company's growth through acquisitions of other companies is facilitated by exchange of publicly traded stock.

9.5.2 Disadvantages

If significant percentages of stock are sold, loss of effective control of the company could result. Entrepreneurs accustomed to running their own show may find it difficult to work with a board of directors they did not choose themselves. Management flexibility will be lost; many desirable corporate maneuvers such as mergers and acquisitions must first gain shareholder approval.

Only shares registered and issued in an offering are freely tradable. Controlling shareholders may not freely sell their shares in the market without registration except under specified conditions. Shares previously issued, for example as management compensation, or issued to accredited investors in reliance on an exemption, are "restricted" and may be resold only in conformity with SEC regulations (SEC Rule 144).

Registration of even the smallest IPO may cost several hundred thousand dollars out-of-pocket. Much of this expense will be incurred even if the public issuance is not completed, for example, as a result of adverse market conditions. Further, ongoing operating expenses will increase as a result of statutorily mandated filings with the SEC, more complex legal and auditing requirements, and the record-keeping and public relations costs of dealing with public shareholders.

Disclosures must be made of the identity, business connections, and compensation of directors, officers, and major shareholders. Major customers and products, as well as their profitability, may have to be revealed. A spotlight will be turned on decisions and actions the company founders will have become accustomed to keeping private. No longer can the company serve as a tax shelter for the owners.

The company's apparent worth—its market value—will be made visible, yet will vary subject to market conditions outside the control of management. "Bottom-line-itis" will focus pressure on short-range operating results. Long-term planning and prudent decision-making may be more difficult to sustain. Lack of steady improvement in operating results may cause public stockholders to lose confidence and to sell their stock. Depressed stock prices cancel many of the advantages of going public.

9.6 Costs of Going Public

A survey of twenty IPOs in 1984 shows that of the twenty, twelve issues between \$3 million and \$4 million cost an average of \$229,000 in total printing, legal, accounting, and filing fees. Eight of the twenty offerings between \$7 million and \$9 million averaged \$441,000 in costs. Selling commissions deducted from the proceeds of the offering—varying from 6 percent to 10 percent—are additional. Most of these costs would be incurred even if market conditions or SEC rulings forced the cancellation of the offering.

Because costs vary so widely from offering to offering, it is difficult to estimate typical fees. Excluding the underwriter's commission, which ranges from \$600,000 to \$1 million and is deducted from the sales proceeds, a \$10 million offering might incur these representative out-of-pocket costs:

Legal fees	\$125,000
Accounting and auditing	\$ 75,000
Financial printing	\$125,000
Filing fees (SEC, NASD, state)	\$ 25,000
Transfer agent, registrar fees, other costs	\$ 50,000

Accounting and auditing costs can be less for the company with good internal control, well-kept records, and a several-year history of physical inventory counts observed by an independent CPA. Legal fees vary widely and must be closely monitored. Printing costs depend upon the number of and the length of the prospectus(es); the necessity for corrections, use of drawings, photos, or maps; and the number of stock certificates. Ongoing costs for stock transfers, SEC filings, and added accounting and legal work can be estimated at $50,000 to $100,000 annually. Additionally, CEOs report that the process of registration consumes management time, significantly diverting attention from operations for six months to a year. Afterwards, many companies find they must staff an ongoing "department of stockholder relations" to act as a communications buffer between shareholders and officers.

Costs are considerably less for nonpublic sales under an exemption from registration. However, against this must be balanced the likely restrictions on subsequent public trading of the issued shares.

9.7 Deciding to Go Public

The decision to go public is best made by balancing the benefits of market valuation and liquidity against the loss of privacy in management. Underwriters report that the equities market seems most receptive to IPOs having these parameters:

— An operating history of five years or more

— Annual sales of at least $20 million

— Net income of $1 million or more

— A demonstrated annual growth rate of at least 25 percent

— A justified need for at least $5 million in capital, since many of the costs of the offering itself are fixed

— Promise of a "niche" position in their industry as a result of a unique product or technological process, the value of which can be readily perceived by the investment community

— A management team having breadth and credibility, preferably with one or two executives who have been successful in taking a company public

If a public offering is made prematurely and the stock flounders because growth is not sustained, permanent damage may be done to the issuer's credibility among employees, investors, and customers. Raising capital in the public market afterward may be nearly impossible; "too public, too soon" is a refrain heard often from CEOs.

9.8 Planning

Much work must be done before going public. Assistance to the company by a CPA and an attorney will be needed to evaluate and carry out numerous steps:

— Prepare a business plan.

— Prepare a capital forecast of needs for several years.

— Calculate the effect that alternative offerings of various sizes and prices would have on earnings per share and book value.

— Improve internal accounting control to allow for efficient auditing.

— Begin audits of financial statements in anticipation of SEC requirements, keeping in mind that auditor independence is defined by SEC rules that are more stringent in one respect than those of the AICPA; independence is lost for the CPA firm when it, its partners, or employees perform any general accounting or bookkeeping functions for the client. Advise changes to generally accepted accounting principles. (One-time changes for the purpose of going public are presented as retroactive restatements.)

— Review present shareholder records for accuracy.

— Discuss implications of related party transactions and arrangements.

— Call in loans to management and other insiders.

— Restructure contracts, particularly with insiders or other related parties, to conform to good business practices.

— Determine that significant contracts and employment agreements have been reduced to writing.

— Reevaluate existing plans or implement stock option plans that may be easier to pass before going public.

— Authorize additional shares for the public offering and future acquisitions or sales.

— Formalize record-keeping of minutes of stockholders' and directors' meetings.

— Consider desirability of splitting stock, adjusting par value, retiring preferred or special classes of stock, eliminating the preemptive right, or otherwise adjusting capital accounts to create a simple and understandable capital structure.

— Combine affiliated companies to consolidate interrelated entities.

— Amend articles of incorporation and by-laws to be consistent with needs of a public company.

— Restructure the board of directors to replace family members with persons having widely recognized business credentials, such as bankers, retired executives, attorneys, and certified public accountants.

— Consider election of an outside director who has experienced the process of going public.

— Establish an audit committee of the board of directors.

— Evaluate the need for a more experienced management team.

— Begin providing information to the financial community before entering the registration pipeline, since to begin doing so during registration will violate SEC rules.

— Compromise, or otherwise settle litigation, since investors will avoid "buying a lawsuit."

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INDEX

All references in this index are to the chapter title and chapter section numbers. The following is a key to abbreviated references used in the index.

Chapter	Index Abbreviation
Sole Proprietorships	PROP
Partnerships	PART
Corporations	CORP
S Corporations	S CORP
Securities Regulation	SEC