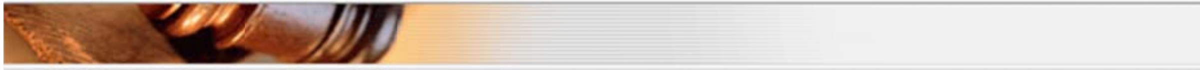
CORPORATE ASSISTANCE
Compliance Management for Business Owners



Twelve Common Pitfalls

This paper outlines twelve governance and compliance failures business owners commonly commit or false notions they incorrectly assume to be true. Now may be a good time for you to assess your present situation. If you fear some of these pitfalls may apply to you, contact us right away so we can assist you to take corrective action.

1. I registered with the State and got a Tax ID# - I'm Done!

We hear this all the time. Many business owners don't understand that ongoing corporate governance is the price for the liability protection of a corporate veil. Statistically, veil piercing cases succeed between 67-96% of the time, primarily because owners ignore governance requirements. Veil piercing is the classic "stealth" business problem – it's often invisible until it's too late.

2. Sole Shareholders Neglect Formal Meetings

Many businesses consist of sole shareholders, who also serve as President, Secretary, and Treasurer of their business entity. The idea of holding formal corporate meetings with oneself sounds silly, and many owners fail to do so. However, single shareholder corporations run the greatest risk of veil piercing, precisely because no other owners are helping to drive formal corporate behavior. This is where we shine, since we walk you through all the required protocols and formalities.

3. Wrongly Assuming Your Attorney/CPA is Taking Care of Governance

Very few CPAs and attorneys handle corporate governance for their clients. Nothing in a typical CPA's training prepares them to offer corporate governance. Few attorneys provide ongoing compliance management, because most don't have the specific expertise and can't afford to do so when operating on a "billable hours" model. Corporate governance involves lots of monitoring and detailed task work, which is precisely why many business owners neglect it.

4. No Paper Trail

Few business owners bother to maintain proper corporate behaviors, let alone document them. In an audit or litigation, usually the first thing requested is your corporate record. One new client had suffered through a lengthy, expensive IRS audit simply because he couldn't produce Articles of Organization for his LLC when the IRS demanded it.

Another common problem is no ownership trail - no stock ledgers, certificates, or records of stock transfers. You can't even prove you own your corporation without a duly authorized and executed stock certificate. You must properly document all actions impacting corporate ownership or face serious legal and tax consequences. We can help you replace missing documents.

5. Ignoring Governance of Passive Entities

Many business owners have multiple entities – some with employees, vendors, and customers, and other "passive" entities used to hold and protect assets. Some owners think passive entities have no risk and don't require governance. This is not true – every business entity requires ongoing governance. When you lack customers, vendors, and employees, you have a higher burden to demonstrate that you have a bona fide business entity, and not just a sham created for personal convenience.

6. Undocumented Business Loans

Small business owners periodically need to take or make loans in order to manage cash flow. These loans are often between business entities controlled by the same owners or between an entity and an owner. Frequently this is done informally and without documentation, particularly in sole shareholder entities. Loaning funds is fine, as long as the loan is documented, collateralized if necessary, and contains specific repayment terms and conditions. When businesses fail to document loans, they create big red flags for courts or the IRS. The courts call this "commingling", and it is a common pitfall.

7. Cutting Corners in Tax and Estate Planning

In the final months of the year, we frequently encounter high income individuals seeking ways to avoid heavy income tax burdens. They often consider tax or investment strategies that require use of a business entity. We also see individuals using business entities as part of an estate or asset protection plan. There are numerous tried and true strategies that enable you to protect assets, plan your estate, and reduce income and estate taxes by using business entities.

Unfortunately, most people tend to cut corners where entity governance is concerned. The IRS is increasingly aggressive in auditing estates that have done systematic planning. For example, estate tax return reviewers have been instructed to "select 100% of the family limited partnership cases" for audit. Don't cut corners – if you create an entity, properly govern it.

8. Overlapping Business Assets

Often, multiple businesses will share the use of common assets. For example, physicians or dentists with separate practices share office space, staff, or medical equipment. A real estate developer creates different entities for each new building project but runs them all out of the same office. An entrepreneur dabbles in multiple businesses at the same time, using the same address and employees for them all.

Sharing assets is fine if you follow the rules. If a business uses another business' asset, it should have a documented use agreement that specifies payment or other consideration in exchange for use privileges. If you break the rules, the courts call this "overlap". Overlap is a key fact in many veil piercing cases. A group of separate healthcare practices was found to be overlapping, and was deemed to be operating as a de facto general partnership. This gave each practitioner unlimited liability for actions of any of the other practitioners.

9. Sloppy Gifting of Business Interests

One classic estate planning technique involves creating a business entity, transferring ownership of an asset into the entity, and then gifting ownership in the business entity to family members or loved ones. Properly done, this yields great benefits – it protects assets, enables wealth transfer, and lowers estate tax liability. However, as with any business transaction, certain protocols and requirements must be followed.

We frequently find clients who have failed to properly gift business interests. Gifts were not properly documented, IRS rules were not followed, or gift recipients have failed to fulfill their responsibilities as partners in the business. The IRS reacts badly to these occurrences, and levies heavy penalties against the entity and the contributing business owner.

10. Poorly Executed Income Shifting

Income shifting is a powerful tax planning method. Income shifting uses business entities to shift income from an individual in a high tax bracket, such as a parent, to individuals in lower tax brackets, such as children. Done correctly, this is a safe and well established practice that can lower taxes by thousands annually.

Problems with income shifting invariably occur when a client sets up a business entity (usually with the help of an attorney or CPA) and then shifts income without maintaining the structure properly and staying abreast of

new IRS rules. Improperly done income shifting is deemed by the IRS to be “assignment of income”, which is against the law.

11. Believing LLCs are Un-Pierceable

We produced two different whitepapers on the topic of LLC veil piercing, so we won’t belabor the point. In short, while state laws on LLC liability are still evolving, all the available evidence makes it clear that LLCs can be pierced, have been pierced, and will be subject to the same governance standards as corporations.

We are often approached by people who tell us “my advisor says an LLC is great because I don’t have to maintain it and it can’t be pierced”. This is bad, inaccurate advice. Please don’t allow yourself to become exposed by failing to maintain any and all of your business entities properly.

12. Undercapitalizing Companies

Undercapitalization might be the quickest and surest path to veil piercing. When you form a company, you must fund it with sufficient resources to fulfill its business purpose. Proper capitalization is a perpetual need and a moving target - capitalization requirements change with business circumstances.

One client enrolled a business entity that had reported millions in revenue over several years, but was capitalized with less than $100. That entity would have collapsed under the slightest scrutiny, leaving the owner with potentially millions in tax liability. In the state of California, if undercapitalization is proven, nothing else is required to successfully pierce the veil.

Summary & Conclusion

We are passionate about helping our clients avoid governance pitfalls. On a daily basis, we are busy cleaning up problems created in part because someone wasn’t paying attention to business entity compliance.

Governance pitfalls are dangerous particularly because they are poorly understood. We have been assured countless times by CPAs, business owners, and even attorneys that everything is “fine”, only to uncover serious gaps as part of our compliance audit process.

Thanks for believing as we do that if a business entity is worth having, it is worth maintaining.

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