

## THE MYTHS OF CORPORATE FORMATION AND COMPLIANCE, PART I

### ***Myth: In order to form a corporation, I only need to file the Articles of Incorporation.***

It is not true that a corporate entity is fully formed with the filing of the Articles of Incorporation (or in the case of a Limited Liability Company, the Articles of Organization). Many times the question is asked, “I formed my new corporation by filing the Articles of Incorporation, now what do I need to do?”

**Filing the Articles of Incorporation is just the beginning** of setting up and establishing a corporation. There are many further actions to take and documents to prepare including the preparation and adoption of the Bylaws and the many transactions that occur prior to the stock issuance and exempting the stock from registration with the Department of Corporations. Some of those transactions are outlined below.

1. **Prepare Bylaws.** Bylaws are regulations that a corporation makes for its internal government, the management of its property, the regulation of its affairs and the transfer of stock. The bylaws cover issues such as a) Directors powers; b) Number of directors; c) Election and tenure of directors; d) Compensation and expenses of directors; and e) Indemnification of directors.
2. **Conduct and document the Organizational Meeting.** The purpose of the First Organizational Meeting is to attend to such matters as the ratification of the Articles of Incorporation, adopt the Bylaws, elect officers, authorize the establishment of bank accounts, adopt a fiscal year, ratify actions of the incorporator, and authorize the issuance of stock certificates.
3. **Apply for Federal Employer Identification Number** with the IRS by filing Form SS4.
4. **Make “S” Corporation election timely, if applicable** by filing Form 2553. There are strict and immediate deadlines, which if missed, can have adverse financial implications. For further detailed information, please read, *THE MYTHS OF CORPORATE FORMATION AND COMPLIANCE, PART II – THE “S” CORPORATION EXPLAINED* © 2012-2024 Tamara L. Harper.
5. **Capitalize the corporation** e.g. fund the company with money and/or property. Under capitalizing a company can lead to problems further down the road. Shareholder loans, capital contributions and amortization of startup costs need to be documented by your CPA and by corporate resolution.
6. **Order corporate records book**, if not done so already.
7. **Issue stock certificates** with the appropriate stock restriction legends.
8. **Complete Stock Transfer Ledger.**
9. **Exempt stock from registration** with Department of Corporations by electronically filing the Notice of Exemption Under Section 25102(f).



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10. **Prepare Buy Sell Agreement** and discuss “Key Man” Insurance.
  11. **Prepare Close Corporation Agreement**, if applicable.
  12. **Prepare Medical Reimbursement Plan**, if applicable.
  13. **Prepare Shareholder Management Agreement**, if applicable.
  14. **Calendar annual filing deadlines** for the Statement of Information and Board of Director and Shareholder meetings as set forth in Bylaws or Organizational Meeting.
  15. **Prepare necessary** executive compensation agreements.
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### *There's more to Articles than meets the eye...*

Most often when a business entrepreneur comes into my office with an internet company packaged kit or a local document preparation service I find that not only have they spent \$1,083.00 (in a recent instance) but often only have the Articles of Incorporation and a great deal of packaging that has quite impressive branding and sometimes a CD Rom or DVD with extensive information. Nothing further has been prepared and the Articles are often lacking the extensive liability indemnification provisions that I believe are mandatory as well as woefully lack stock issuance or worse set a par value. I am frequently in the position of explaining that the Articles need to be redone correctly and re-filed. This involves another Secretary of State filing fee and the re-ordering of stock certificates. To date, I have never once seen Articles done correctly by one of these one stop shop either internet or local companies. I tell people to ask for their money back. I have learned that they are often told that they cannot give legal advice and can only provide a form, which the client must tell them to add or delete to. So in the end instead of saving money doing it right the first time with an attorney, the entrepreneur is out of pocket \$1,000.00 which is a waste of their money and their time.

### ***Myth: My corporate records book is not necessary. I filed the Articles, why bother with anything else?***

The reason for forming a corporate entity in the first place is to have the liability protection if the corporation is sued and so that the corporation can sue in its own name. However, in order to have this protection, the corporation must: (a) be completely formed; (b) adequately capitalized; (c) corporate governance completed annually; and (d) be in good standing with the Secretary of State. Additionally, owners may not commingle funds or run the company as an “alter ego,” e.g. running private costs and expenses for oneself through the corporation.

There are formation requirements in addition to annual requirements that are commonly referred to as corporate governance or compliance. Failure to file or late filing will result in monetary penalties.



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## **Annual Statement of Information**

The State of California requires that an Annual Statement of Information be filed within three months of filing your initial Articles of Incorporation and thereafter on an annual basis on the anniversary day of your Articles. A nominal annual fee is charged by the Secretary of State and penalties may be imposed for not filing such or for a late filing. You are responsible for meeting the deadlines: the Secretary of State will not remind you.

## **Annual Board of Director and Shareholder Meetings**

Annual corporate Board of Director and Shareholder meetings must occur and minutes must be prepared in order to keep your corporate records up to date. These minutes must nominate and elect directors, approve the prior year financial records, and ratify the acts of the officers and directors at a minimum each year. The Board minutes further will nominate and appoint officers of the corporation. Transactions that have occurred throughout the past year should be evaluated to determine whether or not they warrant documentation through resolutions and other documentation e.g. the shareholders have loaned the corporation monies throughout the year. A resolution in this instance would be required together with a promissory note. There are other transactions that may have occurred such as equipment purchases, contract execution, premises leased, credit lines established, etc. that would require independent resolutions.

## **Corporate Records Book**

The corporate books consist of the original Articles, Restated and Amended Articles, Bylaws, Organizational Meeting Minutes, Annual Board of Director and Shareholder Minutes, Buy Sell Agreement, Shareholder Agreements, Close Corporation Agreements, Application for Federal Tax Identification Number, S-Election Application, Stock Transfer Ledger, Stock Certificates, and Notice of Exemption from Registration. I also recommend that corporate loan agreements, promissory notes, leases, patent registrations and trademark registration certificates and assignments be included within the corporate records book. Nonprofit corporations have different documents, and are not addressed within this article.

The documentation of the annual transactions provides a defense to an alter ego theory being asserted against the principals of the corporate entity in the event of litigation. A Defendant may subpoena the corporate records book in order to look for deficiencies, lack of compliance with annual filings, evidence of commingling funds, and other evidence of running the corporation as a separate person for personal purposes and gain in order to pierce the corporate veil. If the liability of the corporation does not hold up under this scrutiny, then the Defendant will pursue the principals personally attempting to reach their personal assets beyond the corporation. Should this occur, the purpose of having a corporation is for not.



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## Piercing the Corporate Veil

In certain limited instances, creditors or litigants can attempt to impose personal liability on principals in a Close Corporation by claiming that the corporation is a sham, a device created merely to defraud creditors, or is being run as a sole proprietorship (e.g., there has been a commingling of corporate and individual property, the entity was not properly formed, formalities have not been followed, or the entity was not properly capitalized).

The process of imposing individual and personal liability is referred to as “piercing the corporate veil,” or “disregarding the corporate entity.” Ordinarily, a party seeking to pierce the corporate veil will have a heavy burden in attempting to persuade the courts to disregard the corporate entity.

In order to maintain your corporate liability protections it is crucial to keep your corporate records up to date and the annual filings, including the corporate tax return, timely.

Corporate records governance and compliance and keeping such up to date is crucial to asserting a defense in litigation and be able to commence litigation as well as defend litigation through the corporate entity and shield your personal assets and wealth.

Taking the time to effectively communicate with your corporate counsel and allowing the corporate governance process to occur on at least an annual basis by your counsel is essential to maintaining the corporate liability protections.

Staying in compliance with California corporate laws is overwhelming. Tamara L. Harper, Esq. advocates and protects not only your corporate interests but also your employment and labor law liability exposure. Tamara L. Harper understands how you all feel, as she is an employer and manages a corporation too. Many of her clients felt the same way too before they worked with her. Ms. Harper’s clients have found as a result of working together, that they feel confident in the final outcome of their situation.

Tamara L. Harper’s unique competitive advantage is that she is very approachable as an attorney, which makes her clients feel at ease and in capable hands and further brings twenty years of litigation experience as a trial attorney to the drafting table. Tamara Harper, Esq. is an aggressive fighter that is reliable and ethical. Ms. Harper not only offers quality work, but enjoys a good location in Westlake Village, California. Tamara L. Harper prides herself on her good personal and business relationships with clients, and the use of her insight and knowledge to obtain successes for each client.



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### Costly Lessons

*Save \$750 in Legal Fees Now – and Lose \$20,000 Later*

*A client brought me a letter from the Secretary of State imposing a \$20,000 penalty together with interest. She explained that she prepared and filed Articles of Incorporation for Smuckers, Inc. five years ago and decided to not pursue the business. She never obtained a Federal Tax Identification Number, earned money, or issued stock. She did not file any statements with the Secretary of State. She relied on advice that she need do nothing.*

*The Secretary of State imposed a \$250 late penalty and \$25 filing fee for each year the Statement of Information was not filed. The Franchise Tax Board (FTB) imposed the minimum tax obligation of \$800 per year together with interest at 10% and penalties at 6%.*

*I prepared the Certificate of Dissolution and Notice of Election to Wind Down & Dissolve and corporate resolution. Her CPA prepared tax returns for each of the 5 years and calculated interest due on the \$800 franchise tax fee each year. (After much research it was determined that all 5 years were required to be prepared and that the IRS in January 2009 extended the statute of limitation on tax debt to 40 years). The Secretary of State rejected the dissolution documents since the FTB suspended the corporation. The only way to have the suspension lifted was to 1) wait for the FTB to process returns and lifting suspension; 2) apply for a Certificate of Revivor; and 3) resubmit the dissolution papers.*

***Cost to prepare dissolution: < \$1,000***

***Cost of not doing it right from the beginning: \$20,000***

***The anxiety of not knowing the fees, penalties, interest: Incalculable***

***Myth: I have ceased doing business in my corporation – there is nothing further that I need to do.***

In addition to filing the Certificate of Dissolution and Notice of Election to Wind Down and Dissolve with the Secretary of State, appropriate Board of Director and Shareholder resolutions are required. Coordination with your CPA and attorney is key, as they will play an important role in making sure the final documentation is prepared and filed and the distribution of assets and profits/or losses is done correctly. The final tax return is mandatory to be prepared and there are time sensitive issues involved with such. Until the Certificate of Dissolution is filed by the Secretary of State, the annual Statement of Information is still required to be prepared and the filing fees paid together with the minimum franchise tax fee.

The old advice from days of old that you simply just “walk away” and let the corporate entity “fade into the sunset” are gone. The State of California is very aggressive in seeking lost revenue from inactive corporations.

Wanting to avoid spending the money to do it right in the first instance and listening to poor advice can lead to a \$20,000 mistake together with the added costs of CPA preparation and attorney time. When an entity is suspended, the FTB will not negotiate penalties or interest. There is no filing fee for the Dissolution documents to be filed with the Secretary of State, so they too are unsympathetic to the waiver of penalties. In their opinion there is no excuse not to file the Certificate of Dissolution.

Not only is the FTB very aggressive but the IRS is just as aggressive. Failure to file IRS Form 966 (Corporation Dissolution or Liquidation) which is required under section 6043(a) of the Internal Revenue Code, will result in further imposition of penalties by the IRS. The form is very short and takes no time to complete at all. It should be prepared and filed with the corporate entity’s final tax return.

