

# Lake County Contractors Association Professional Practice Report

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## THE FORMALITIES OF CORPORATE OPERATIONS

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Operating a business in corporate form can be advantageous, but the benefits may not be automatic. Different businesses may be looking for different advantages so all of the items on the following list may not apply to all businesses:

1. Shareholders of a corporation are not liable for corporate debts. This is usually called "limited liability." In most cases, this is vital to a construction contracting business, and is usually the primary reason for incorporation.
2. At low levels of corporate income the corporate tax brackets are lower than individual tax brackets, but at higher levels of corporate income the corporate brackets may be higher.
3. Shares of stock in a corporation are easier to transfer by sale, gift, etc. than is interest in other entities.
4. Management of a corporation may be simplified by statutory rules providing for officers and directors, and how they vote and manage. Because these rules are provided by standard laws, less contractual documents may be needed.
5. A corporation can elect to be taxed substantially as if it were a partnership. Accordingly, if corporate taxation would produce a higher rate, or even cause double taxation as it sometimes can, the advantages of limited liability can be secured, while preserving what might be advantageous non-corporate taxation.

Incidentally, there may be disadvantages to doing business in corporate form, but they are not the subject of this article.

Limited liability is the most common reason for incorporating a business. Business people can invest a limited amount of money in a business and be reasonably certain that the investment is all that can be lost in the event of a business failure or major lawsuit. In the case of a business failure, people with whom contracts were entered into are likely to seek to enforce the contracts against the shareholders, corporate employees and agents. The creditor may succeed if able to prove either of the following facts:

1. The corporation signed the contract, but because it did not observe the formalities of corporate operation, it should be ignored. This is commonly called "piercing the corporate veil."
2. The corporation existed and was operated properly but it wasn't the party that signed the contract. This is simply a question of the identity of the contracting party. The failure to sign a contract in a corporate name may obligate the person or entity in whose name the contract was signed.

Consider the following procedures to avoid the piercing of the corporate veil and to be sure that the corporation is the contracting party:

1. Present your business to the public as a corporation, by observing the following formalities:
  - a. Use the precise corporate name in contracts, advertisements, stationery, business cards, forms, etc. The name of your business is "ABC Contractors, Inc." not ABC Contractors."
  - b. Corporate management should make it clear that they are acting on behalf of the corporation. For example, a contract should be signed as follows:  
ABC CONTRACTORS, INC., an Illinois  
Corporation  
By: JOHN JONES  
PRESIDENT
2. All corporate documents required by the Secretary of State must be filed. In Illinois this is the annual report, assumed name applications and appropriate reports of issuance and cancellation of stock.

3. The corporation should maintain a complete book of minutes of the meetings of its board of directors and shareholders. Those meetings should take place at least annually and more often if special transactions are entered into, such as loans, sales or purchases of assets out of the ordinary course of business, transactions in the corporation's stock, etc.
4. Insurance policies must be in the corporate name, and the insurance company must know that the insured party is a corporation. This may not have a substantial effect at avoiding a piercing of the corporate veil, but it will secure the needed protection in that event.

A business which is financially healthy, able to pay its debts and thinking it will always be that way may not be very concerned with limited liability issues, but there may still be a large liability lawsuit in its future. Of course, adequate insurance is always the best protection, but if the insurance proves to be inadequate, there's no better secondary protection of shareholder assets than the limited liability provided by a corporation. Observe the formalities and you'll probably achieve it.

Taxation is usually the second concern of corporate operations. It is not difficult to keep the kinds of corporate records required to accomplish the tax objective. The following will usually suffice:

1. Salaries and bonuses paid to officers, directors, and shareholders should be determined at corporate meetings, and recorded in the minutes. To avoid the Internal Revenue Service's argument that the salaries were determined hindsight; the determination should be made near the beginning of the corporate year. Since only "reasonable" salaries are tax deductible, it is important that salaries be kept to a reasonable level, but there is little guidance as to what reasonable means.
2. Transactions involving corporate tax should be authorized by corporate resolutions, and recorded in the corporate minutes.
3. Special care should be taken to document transactions between the corporation and its shareholders, officers or directors, including proof that the transaction had a business purpose and were at least as favorable to the corporation as if the transactions were engaged in with an unrelated party. It is best, but not always possible, to have the shareholders and board of directors approve the transaction without the related party or any family member voting.
4. Officers and directors should be elected annually, even if there are no changes.
5. The acts of the officers and directors should be approved annually.

Observing the corporate formalities is not really difficult. It just requires some adherence to detail. Tending to the issues may pay off in the long run.

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