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For many years, attorneys have been able to provide legal services for close corporations without considering whether their actions may result in unwanted tax consequences. In this article, Mr. Wass points out that in future years, attorneys may have to exercise a higher degree of care in these matters, in order to avoid possible law suits or in the very least professional embarrassment. He goes on to explain how proper documentation of corporate affairs not only protects a lawyer from such possibilities but also provides one's client with valuable protection when dealing with the Internal Revenue Service.

HOW DOCUMENTATION AIDS TAX PLANNING FOR THE GENERAL PRACTITIONER'S CLOSELY HELD CORPORATE PRACTICE

Michael L. Wass*

If you could look into the seeds of time, and say which grains will grow and which will not speak then to me.

Shakespeare, Macbeth, Act I

Most general practitioners include in their practice a lucrative corporate clientele for which they prepare a wide range of corporate-related documentation. Until recently, they could prepare these documents without concerning themselves with the tax consequences of their work product. However, with the increasing number of law suits filed against all professionals, including attorneys,¹ it appears

¹ According to I.N.A. Corporation, an insurance company which provides professional malpractice insurance, "The number of claims against attorneys and legal firms has doubled in the last 15 years. In 1977, it is estimated that approximately 15,000 malpractice cases came to trial or were settled out of court. And over the past two years the average award against lawyers has risen 200% - to about $28,000." Forbes, Advertisement, Aug. 21, 1978.
that the general practitioner would be advised to have at least a cursory knowledge of the basic tax effects of the documents he prepares — if not to avoid a law suit, then to avoid embarrassment upon revelation of a tax consequence not considered until after the completion of the business transaction.

Presently, there is no reported case where a general practitioner has been held liable for damages because of the tax effect of a corporate document he has drawn or an omission he has made. However, the following query made in 1960 seems ominous and by analogy can be related to the handling of corporate matters:

A number of problems remain unsettled... To what extent will specialties affect the services of the ordinary practitioner? Suppose, for example, that an attorney draws a will for a client without paying any attention to the tax aspects, with the result that a substantial tax savings is lost. Will the ordinary practitioner be expected to give consideration to the tax aspects of the transactions he conducts, on pain of being found negligent if he simply ignores them?²

Further, consider the following evidence that such suits have actually been filed:

Most recorded legal malpractice decisions involve transactions where the tax consequences were collateral to the attorney's assignment in another area of the law. These attorneys did not appear to have been specialists, and few of these lawsuits have advanced beyond the pleading stages.³

Malpractice and negligence aside, some commentators are now stating that all attorneys should be familiar with some basic tax principles.⁴ The ability of a lawyer to spot potential problems and refer them to experts is as critical as his ability to resolve those problems within his area of expertise. Of course, even with an understanding of the basic tax related consequences, it would behoove the general practi-

². T. Roady, Jr. and W. Anderson, Professional Negligence, p. 217, 238-239, (1960); quoting from article written by T. Wade; see also, Lawyers.
⁴. Id. at 368.
tioner to insist that every business document he prepares be reviewed for possible tax consequences by the client’s accountant before signing. This is especially so in forming and representing corporations.5

The general practitioner should not only carefully and accurately draft the documents involved, but should also carefully document his role as legal advisor and the accountant’s as tax advisor. Since incorporating is becoming an important tax planning tool, this article discusses the attorney’s role in preparing corporate documents and their tax effects.

LACK OF PROPER CORPORATE DOCUMENTATION

Although it is relatively easy to incorporate a business, all too often only the articles of incorporation are filed and a corporate book with forms is ordered, but the appropriate blanks are not filled in, signatures are not obtained, and even the stock certificates are not issued. There are two pressing reasons why this type of practice can lead to uncomfortable situations for either the client or the attorney, or both.

First, if the corporation is not properly documented and does not operate as a corporation, the client may face an I.R.S. challenge that the corporate entity is a “sham” with the consequence of corporate deductions being denied.6 Stanley L. Blend, a Texas tax attorney, has stated succinctly what corporate documentation should be utilized to avoid this potential tax problem:

Courts will generally recognize the separate existence of the corporation if the corporation conducts itself like a corporation and proper attention is given to the normal corporate formalities. For example, corporate books and records should be maintained and kept current, corporate minutes should be prepared and executed, reasonable salary arrangements with key employees should be established, preferably in writing, third party agreements should be executed on behalf of the corpora-

5. “Planning is of the utmost importance when incorporating, since in no field of tax law is the opportunity to back up and start over less readily available.” CARL STUTZMAN JR., TAX FACTORS IN ORGANIZING A CORPORATION, 15017.1 (1977).
tion by proper corporate officers in their capacity as such and not by corporate shareholders in their individual capacities, and the corporation should maintain its own stationery, billing statements and other similar papers.\textsuperscript{7}

Further, the Tax Court has held that the corporate entity must not only look like a viable corporation from inception, but must also subsequently act like one.\textsuperscript{8} In an interesting case involving heavyweight boxing champion Floyd Patterson, this attack was utilized in denying corporate existence.\textsuperscript{9} In this case, although the original corporate books and records were adequately prepared, there were no subsequent directors' meetings or minutes, and only one recorded shareholders' meeting in ten years. The court stated:

It is not enough that the corporation be recognized as a separate entity as a matter of local law governing corporations. For tax purposes, it must be given substance through the manner in which it actually operates. This was not done here. Petitioners simply did not put flesh on the bones of the corporate skeleton. Indeed, the bones are so transparent that the corporation should more properly be classified as a wraith.\textsuperscript{10}

Although the lack of corporate formalities was only one factor in the court's disregarding the corporate entity for tax purposes, it does emphasize the need for the general practitioner to stress to the client the lawyer's vital role in keeping minute books up to date.

In \textit{Bass v. Commissioner}\textsuperscript{11}, the court, in finding a viable corporate existence for tax purposes, placed emphasis on the fact that all legal formalities had been followed, including the holding of and recording of directors' meetings and the annual meetings of shareholders. This risk of disregard of the corporate entity can probably be reduced if careful atten-

\textsuperscript{7} Id. at 647.
\textsuperscript{8} Bass v. Commissioner, 50 T.C. 595, 600-601 (1968).
\textsuperscript{9} Floyd Patterson, T.C. Memo, 1966-239.
\textsuperscript{10} Id. Footnote No. 9, at 66-1385.
\textsuperscript{11} Id. Footnote No. 8. See also, Knoxville Truck Sales & Service Inc. v. Commissioner, 10 T.C. 616 (1948).
tion is given to corporate matters and its affairs are handled properly.\textsuperscript{12} An important part of avoiding I.R.S. attack is keeping up all corporate records and books.\textsuperscript{13}

In summary, assuming the corporate charter\textsuperscript{14} is filed, the lack of proper organizational documentation will probably not, by itself, result in a denial of corporate status for tax purposes as a disregard of the corporate entity is the exception rather than the rule.\textsuperscript{15} Organizations that purport to be corporations but have failed to attain \textit{de jure} status under local state law have been held taxable as corporations, either on the theory that the term “corporation” includes organizations that are \textit{de facto} corporations, or on the theory that a defectively organized corporation is an “association”.\textsuperscript{16} However, the general practitioner should not chance adding one more bit of ammunition to the continual I.R.S. attack on the American taxpayer.

The second reason for adequately preparing the corporate structure deals with the lawyer’s own protection and preservation of his good name. The first request of the I.R.S., following notice of an audit, is to request the corporation’s books and records. It is a common practice for many general practitioners to quickly update uncompleted minute books just prior to the date of the audit.\textsuperscript{17} Often times they will be dated as if they were prepared all along during the corporate existence. This practice may become a trap for the unwary.


\textsuperscript{13} It is interesting to note that with the exception of Internal Revenue Code Section 6043 (Resolution or plan of liquidation), Sec. 6001 (Business Needs), Sections 401-415 (Retirement Plans, and Reg. Sec. 1 368-1(c) (Corporate Reorganizations), there is a dramatic absence in the code of requirements on the preparation of corporate records.

\textsuperscript{14} See, Frentz v. Commissioner, 44 T.C. 485 (1965), \textit{aff'd per curiam}, 375 F.2d 662, 19 AFTR 1194 (6th Cir. 1967) where the corporate charter was not filed before the corporation attempted to file a Subchapter “S” election and as a result the tax election was held invalid.

\textsuperscript{15} 7 \textit{MERTENS, LAW OF FEDERAL INCOME TAXATION}, § 38.15 (1976 Rev.).

\textsuperscript{16} BITTKER & EUSTICE, \textit{FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS}, § 2.08 (1971).

\textsuperscript{17} It has been stated by the Tax Court that minutes prepared after notice of an audit are entitled to “little or no consideration.” A. C. Engineering Corporation v. Commissioner, T.C. Memo, 1958-147 (1958). In a recent Tax Court decision, a corporate president and majority shareholder withdrew funds from the corporation for his personal use. The withdrawals were treated as loans with some promissory notes issued. Just before an IRS audit, notes were issued for all the loans and some interest was paid. However, because it could not be proven that repayment was intended, and the notes were issued and interest paid only just before the IRS audit, the withdrawals were treated as distributions taxable as dividends. Williams, T.C. Memo, 1978-306, ¶78, 305 P.H Memo TC.
Since the back dating of a president's gift by his attorney and the subsequent prosecution and other recent prosecutions, the back dating and post dating of corporate minute books should be avoided at all possible cost. However, there is presently little significant law on the subject as criminal prosecutions are rare absent proof that the transactions are specifically intended to disguise income. How the minutes will be treated upon close scrutiny appears to turn on whether the minutes back dated or post dated would affect a tax consequence different from that if they had been dated as of actual signing, together with an actual willful avoidance of tax imposition. The problem can clearly be avoided by proper document preparation:

Where the disparity of execution from effective date of the transaction, or agreements between the parties, is clearly evidenced in the documents, then no fraud could occur since the issue of tax consequences and effectiveness of the agreements of the parties to control tax consequence as of some given date is clearly highlighted and subject to examination.

Accurate dating should always be used when preparing minutes, especially when including information concerning such things as accumulation of earnings for business expansion, medical reimbursement plans, bonuses for employees, pension contributions, raises, and all other transactions affecting the taxation of the corporation or its shareholders.

**Corporate Documentation Upon Incorporation**

Once the client and his tax advisor have made the decision to incorporate, the following documents and techniques can aid the general practitioner in his efforts to properly serve and advise his client, as well as document his role.

18. United States v. DeMarco, 550 F. 2d 1224 (Cr. No. 75-3824, 9th Cir. 1977).
20. Id. at 1245.
22. Id. n. 20.
23. Id. n. 21.
24. "Don't backdate any document unless the document must speak 'as of' a certain date and then use the words 'as of' and correctly cite when signatures were actually appended to the document." Id. Footnote No. 12, at 1252.
A. Letter of Accountant's Advice

If the client's accountant is not at the initial conference and if the client has no objections, a letter should be forwarded to the accountant advising him that articles of incorporation are being prepared and the approximate date they will be signed. The accountant's concerns about the pending corporation and its tax implications, if any, should be solicited. This letter in the file and the response avoids later questions about the lawyer's role prior to incorporation.

B. Articles of Incorporation

Once the articles of incorporation have been carefully drawn and filed with the Secretary of State's office, a copy and cover letter should be forwarded to the client's accountant. The importance of this step cannot be overemphasized because if the accountant decides that the corporation should elect to file a Subchapter "S" election for tax purposes, he will need to do so within a 30-day period. The letter should state when the corporate stock was or will be issued and when business began or will begin. Failure to file the election within the prescribed period can lead to disastrous results. Although, under appropriate circumstances, this letter could be sent at a later date, however if it is always sent following filing of the articles of incorporation the chance of error will be minimized.

C. Organizational Meeting Minutes

An effective tool for avoiding tax problems and embarrassment is the Organizational Meeting Minutes. This form need not vary significantly from corporation to corporation. Under the Wyoming Business Corporation Act, the incor-

25. "Too often the drafting of articles of incorporation consists in the mere filling out of blank official forms without consideration of details as to capitalization or the inclusion of permissible but not necessary provisions. Such practice may result in future trouble and vexation," Fletcher Corporation Forms Annotated, § 173, (1972).

26. The Subchapter "S" election is a special provision enacted by Congress to avoid the double tax imposed on most corporations. However, for a corporation to avail itself of the election, Form 2553 must be signed by the shareholders and filed during the first month of the taxable year if it is to be effective.

27. To compute the 30-day period, the accountant will need this information because the first day of the taxable year begins when the corporation has stockholders, acquires assets, or begins business. 6, Prentice-Hall Taxes § 33,373 (1978).

porators designate the initial directors of the corporation, and therefore, upon issuance of the charter, the directors may proceed with carrying on the corporation business.

One goal of the corporate organizational meeting is to acquaint the client with the new business entity and its method of operation. Reviewing the written minutes of the organizational meeting enhances the lawyer's explanation of this new entity.

Along with the typical recitations of election of officers, adoption of by-laws, the minutes should reflect the following:

1. Attendance

The minutes should reflect the attendance in case of later question as to advice rendered. Most importantly, the corporate accountant should be scheduled to attend the meeting. His advice is crucial to properly organizing the corporation and further clarifies the general practitioner's role in the formation of the corporation.

2. Subchapter S Election

The minutes should reflect whether the accountant has advised the shareholders to file a Subchapter “S” election or not.

3. Property Transferred

The minutes should reflect the character of assets being transferred into the corporation and most importantly, any debts owed on the assets. Further, the minutes should reflect any other liabilities assumed by the corporation. The purpose of this provision is to insure that the client is informed by the accountant that any liabilities assumed by the corporation in excess of his cost basis in the assets will be considered "boot" and he will be taxed. Most clients do not anticipate paying a tax on incorporation but rather expect a tax-free incorporation. Nevertheless, there will be cases where the accountant will suggest a taxable incorporation, usually to step up the basis in certain property being transferred, and the minutes should reflect this decision.  

30. Id. at 709.
4. Stock Issuance

The minutes should reflect the stock to be issued and the receipt and type of consideration for the issuance. If a shareholder will receive anything other than stock or securities of the corporation (i.e. property, cash, stock rights, warrants) in exchange for the assets transferred, he will recognize a taxable gain.  

5. 1244 Election

The minutes should reflect that the organizers of the corporation have elected to issue the corporate stock under Section 1244 of the Internal Revenue Code. In essence, a 1244 Election allows corporate stockholders whether or not they elect a written plan the right to receive ordinary loss status for stock that becomes worthless, up to a limit of $50,000 ($100,000 for a husband and wife filing a joint return).

6. Medical Reimbursement Plan

The minutes should reflect whether or not the corporation will elect an Employee Medical Reimbursement Plan. This guarantees that the matter will be considered, whether or not implemented. The plan must be in writing and may be embodied in the minutes or just the authority to enter into a written plan, which is later executed. A Medical Reimbursement Plan allows the corporation to reimburse covered employees for non-insurance covered expenses. The tax benefit is that the corporation gets a deduction for the pay-

31. Id. at 703.
32. To qualify as Section 1244 Small Business Stock:
   (1) The issuing corporation must be a domestic corporation and have no portion of a prior offering outstanding. IRC § 1244(c)(1) and 1244(c)(1)(C).
   (2) The capitalization must consist of one and only one class of common stock. IRC § 1244(c)(1)(A).
   (3) Only individuals and partnerships can take advantage of Section 1244. IRC § 1244(a) and (d)(4); Reg. § 1.1244(a)-1(b)(2).
   (4) The total equity capital of a corporation cannot exceed $1,000,000 and the plan must state the maximum amount of contribution to capital cannot exceed $1,000,000. Treas. Reg. 1.1244(c)-1(d)(1).
34. See, I.R.C. § 105(b).
36. "At present it appears to be sufficient for the plan to consist solely of a resolution in the employer's corporate minutes. However, it is more sensible and safer for the plan to be embodied in a separate document executed by the employer pursuant to authority contained in the employer's minutes." Rosewater, Employee Medical Reimbursement Plans in the Age of ERISA, 10 Akron Law Review 61 (1976).
ment as an ordinary and necessary business expense\textsuperscript{37} and the payment is not recognized by the employee as additional compensation.\textsuperscript{38} An important factor once the plan is instituted is that it should be communicated to the covered employees. A letter from the corporate attorney or accountant announcing the plan and enclosing a copy is a suggested means of handling the communication.

7. Stock Purchase Upon Death

All corporate shareholders should consider the implementation of a stock purchase agreement, either a corporate purchase plan or cross purchase agreement. The minutes should reflect a discussion of this matter and the determination.\textsuperscript{39} Discussing a stock purchase agreement is a critical aspect of properly planning the organization of a closely held corporation and is an excellent estate planning tool. Further, to avoid a later question as to the lack of such a document, the record should indicate a direction whether or not the corporate attorney should prepare the necessary documentation.

8. Corporate Minutes Policy

The organizational minutes may include a corporate minute policy. Such a policy can serve two functions.

First, establishing a policy may clarify questions later on the corporate life if problems arise between shareholder-directors as to the correct method of reporting the corporate minutes. Although disputes over the contents of minutes are probably more likely to arise in large national corporations than in smaller ones, arguments among board members occur in corporations of all sizes; and any such dispute could, conceivably lead to a controversy over the proper method of reporting a board meeting devoted to the subject of the main argument.\textsuperscript{40}

\textsuperscript{37} I.R.C. § 162, Reg. § 1.162-10(a).
\textsuperscript{38} I.R.C. § 105(b).
\textsuperscript{39} "Frequently a client’s greatest asset is his business. A disregard for estate planning considerations at the outset may result in unintended tragic financial loss to the client’s family. The attorney and accountant have an affirmative duty to advise the client of such perils and, without delay, to implement carefully thought-out plans to protect against such perils." Kurzman, \textit{Organizing Business and Estate Planning}, \textit{34 New York Institute Federal Taxation}, 1477 (1976).
\textsuperscript{40} See, Brewer & Solberg, \textit{Corporate Minutes: What Should They Include?} \textit{34 The Business Lawyer} No. 4 (July 1978).
Further, often the corporate accountant will advise that directors' fees are appropriate and should be paid. This minute policy, if followed by the client, could support upholding the reasonableness of the amounts paid if ever contested by the I.R.S. The policy should include mandatory attendance of meetings before a director's fee would be paid, active director's duties outside the corporate meetings and require written reports.  

D. By-Laws

The customary by-laws used by most general practitioners present no tax problems for the client. However, in recent years, the by-laws have been used as a tax planning aid through the use of an "Oswald By-Law". An Oswald By-Law is a by-law taken from a tax court case where an employee-shareholder was required to reimburse the corporation for any payment of salary, bonus, rent, interest, or entertainment expense determined by the I.R.S. or the courts to be unreasonable and, therefore, non-deductible by the corporation. This repayment gives the employee-shareholder an offsetting deduction and puts the money back into the corporation, thus avoiding dividend tax treatment. Some tax practitioners have used this same concept to cover denial of corporate travel and entertainment expenses.

Although this type of provision may be and often is inserted in employment agreements rather than the by-laws, in practice, if its use is suggested by the large salary of corporate shareholder-employees, the best tactical place is in the by-laws which are rarely perused by the I.R.S. For once discovered, a court may take the position that the provision evidenced "a pre-existing knowledge... that the payments would not be reasonable."  

E. Debt Documents

Often a corporate accountant will advise the client to place some funds or assets in the corporation as capital in return for stock and make other funds available to the cor-

42. Oswald v. Commissioner, 49 T.C. 645 (1968).
43. See, Letter Ruling 7811004 and Letter Ruling 7811005.
poration through the use of promissory notes or debentures. The idea is to avoid, as much as possible, locking funds in the corporation until it is sold or dissolved. However, the ratio of debt used to capitalize the corporation as opposed to the equity can cause taxation problems. The suggested ratio is subject to differing opinions\textsuperscript{45} and should be determined upon the accountant's advice, but the lawyer's role can prove vital if the matter is ever carefully scrutinized by the I.R.S.\textsuperscript{46}

Often courts will place emphasis on whether the transaction intended to create a bona fide debtor-creditor relationship.\textsuperscript{47} Therefore, the minutes should reflect the directors' resolution to obtain corporate funding from outside sources, which, of course, will be funds loaned by the shareholders.\textsuperscript{48} Further, there must be an actual written unconditional promise to pay on demand\textsuperscript{49} or on a specified date a sum certain and a fixed interest rate.\textsuperscript{50} Thus, proper documentation is essential to planning the debt versus equity arrangement of the corporation.\textsuperscript{51}

\textbf{F. Employment Agreement}

An often overlooked tax planning aid is a written employment agreement. As previously stated, this document can support the argument of a valid corporate existence, but more importantly, its existence adds credence to a corporation's deduction of a stockholder-employee's compensation as an ordinary and necessary business expense.\textsuperscript{52}

One of the factors courts look at in determining whether or

\textsuperscript{45} See, O'Neal, \textit{Close Corporations}, § 2.10, (2d Ed. 1971).

\textsuperscript{46} In denying the existence of a valid debt structure upon incorporating, the Tax Court has stated: "The minutes of the meetings of the stockholders and directors made no mention of any notes to be issued in consideration of the transfer, nor were the officers authorized to execute any notes." Murphy Planing Mill, Inc. v. Commissioner, 26 T.C. Memo, 1957-33 at 134 (1957).

\textsuperscript{47} Id. n. 46.

\textsuperscript{48} All of the corporation's financial records and minute books should indicate the intention to create a debt at the outset. If the funds are kept in a suspense account and later entered as an obligation or if oral testimony is relied on to establish the debt, an adverse impression will be created that will be extremely difficult to overcome. Cavitich, 3A, \textit{Business Organizations}, § 71.04(5) (1978).

\textsuperscript{49} The use of a demand note should be avoided in closely-held corporations where the creditor is also the controlling shareholder in the corporation. In this regard, in Davis v. Commissioner, 69 T.C. 814 (1978) at 836, the Court stated, "The fact that the notes required payment on demand cannot be considered in any realistic way as an expectation of repayment on the part of petitioners."

\textsuperscript{50} See, I.R.C. § 385(b)(1).

\textsuperscript{51} See, Lowy v. Commissioner, 262 F.2d 809, where a taxpayer was denied loan treatment of certain funds because of the lack of documentation.

\textsuperscript{52} See, O'Neal, \textit{Close Corporations}, § 6.12, (2nd Ed. 1974).
not a payment to a stockholder-employee is a dividend or a salary is whether or not there is corporate authorization for the payment. Thus, once again, corporate documentation and the lawyer's role becomes an important factor in proper tax planning for the closely held corporation.

**Conclusion**

Today's general practitioner can expect a respectable amount of income from representing local businessmen in the formation and operation of closely held corporations. In reviewing tax related litigation and treatises, the general practitioner's important role in representing these clients becomes quite apparent and his effort to properly document the corporation's activities becomes critical. Courts constantly refer to the inadequacy of, or lack of, proper corporate documentation. Granted, much of the missing documentation is materials not usually handled by the lawyer (i.e. bank accounts, ledgers, receipts and the like) but, nevertheless, a substantial amount of concern is over documents within the lawyer's area of responsibility. Thus, it is imperative that this factor is not overlooked as a potential source of litigation or personal embarrassment. Whether or not legal liability will arise in this area only time will tell. Not only would complete documentation aid in giving the client valuable protection from outside interference with his corporate operation, but would also be one step forward in improving the overall image of today's lawyers.

There is an additional factor to consider when reviewing this area of general practice. In the past, it was not unusual for a corporation's books and records to be shelved and never inspected. Today, however, not only are they requested by the I.R.S., but also by the businessman's advisors and potential advisors, such as bankers, financial managers, insurance salesmen and estate planners. This factor could bring up uncomfortable questions concerning the adequacy of services rendered and the general practitioner's desirability as a representative.

profession, the general practitioner would be wise to carefully document his role in handling his corporate clients and, more importantly, attempt to improve our image by diligently preparing and obtaining execution of corporate organizational documentation.