

Business Insider

July 2006 Edition

This Edition:

- Pg 1 Things To Consider When You Incorporate
Pg 2 Valuation Discounts Of Closely-Held Company
Stock For Estate And Gift Taxes

THINGS TO CONSIDER WHEN YOU INCORPORATE

Following fast on the heels of a decision to go into a particular kind of business is the decision about what kind of legal form it should take. The most common options are a sole proprietorship, a partnership, or a corporation. You may lean toward the corporate route because you like the sound of having "Inc." after the company's name, but there are some more practical, business like considerations to take into account.

More so than with some of the other structures for a business, starting a corporation means complying with formalities required by state laws. Once the shareholders (owners) of the business agree on some basic matters, such items are embodied in articles of incorporation that must be filed with the appropriate state agency. These essentials usually include:

- a corporate name;
- the number of shares that can be issued;
- the number of shares each owner will buy and for what contribution of cash or property;
- the nature of the corporation's business; and
- the identity of the directors and officers of the corporation who will handle day to day operations.

The fledgling corporation will also need bylaws, which constitute a procedural rule book for the company.

Decision-making

The bottom line here is that whoever holds a majority of the shares of a corporation has ultimate control over it. Usually it takes a majority of the shares to elect the board of directors, which is charged with making the "big picture" decisions. If a decision is momentous enough for the company's future, such as a change in the articles of incorporation or whether or not to merge with

another company, the shareholders usually have a more direct role in that they themselves must approve the decision by a certain margin of votes.

The board elects the officers of the corporation, typically including a president, vice president, secretary, and treasurer. The officers may or may not be salaried employees or shareholders, and in some cases one person may hold more than one office.

Accountability

At or near the top of the list of characteristics favoring the corporate structure is the fact that, since the corporation is treated as a legal "person" separate from the people who own and run it, the shareholders as a rule are not personally liable for the corporation's debts. Instead, their risk is confined to their investment in the company. To every rule there is an exception, however, and here the exception has the colorful legal name of "piercing the corporate veil." If the owners do not comply with the statutory requirements for running a corporation, or if they blur the lines too much between corporate and personal finances, the legal fiction of the corporation as a separate entity is ignored and the owners are on the hook for the corporation's losses.

Transitions

As a separate entity in the eyes of the law, a corporation does not go out of existence if one or more of its owners dies. Instead, a corporation stays alive until its owners decide otherwise. Transfer of the ownership of the corporation is accomplished by selling its stock. New owners are added either when existing owners sell some of their stock or the corporation itself sells more shares of stock. The smaller the enterprise, the more likely it is that the owners, for whom the corporation may be both their property and their

employer, may agree to restrict the sale of the stock in order to maintain control.

The particular circumstances of each new business and the differences in the governing laws of the states make generalities difficult. That said, the factors on the debit side of the ledger for corporations include the costs of setting up the corporate entity, the need for a separate tax return,

and the burden of “double taxation.” Double taxation means that the corporation is taxed on its profits, and the shareholders are then taxed on their dividends. On the credit side are limited liability for the owners and easy transfer of ownership.

As you can see, there are many things to consider when incorporating. Tinovsky Law Firm can help guide you through this critical process.

VALUATION DISCOUNTS OF CLOSELY-HELD COMPANY STOCK FOR ESTATE AND GIFT TAXES

Upon the death of the owner of stock in a closely held corporation, the fair market value (“FMV”) of the stock must be determined before an estate tax return can be filed. For gifts of such stock, it is also necessary to ascertain the value of the stock for gift tax purposes. Unlike publicly traded stock, the value of which can be determined easily on the Internet or in a newspaper, stock in a closely held business has a value that is more difficult to nail down. By definition, the shares are held by a much smaller number of people and are not widely traded.

Fair market value means the price at which property would change hands between a willing buyer and a willing seller when neither party is under any compulsion to buy or sell and both parties have a reasonable knowledge of relevant facts. Calculating the FMV of closely held stock generally starts with an estimate of the total value of the closely held company itself. Application of discounts (or premiums) to account for the specific circumstances of the company then reduces (or increases) the FMV of the stock.

The process is highly focused on the particulars of each business. For example, in a recent decision by the United States Tax Court, the starting point in valuation of a decedent’s minority interest in a closely held family corporation was easier to figure, because the corporation was a holding company with a portfolio of widely traded securities that had readily ascertainable values. But that market value was discounted by 10% to take into account a buyer’s lack of control over the company and by another 15% for lack of marketability of the shares.

The Internal Revenue Service likes to keep an eye on valuation discounts, since they lead directly to a reduction in estate tax liability. Federal statutes, regulations, and Revenue Rulings have shed light

on the use of valuation discounts. IRS Revenue Rulings have identified the following list of some primary criteria for determining the valuation discounts for closely held stock:

- nature and history of the business;
- outlook for the economy and the specific industry;
- book value of the stock and financial condition of the business;
- earning and dividend-paying capacities of the company;
- goodwill or other intangible value of the enterprise;
- sales of the stock and size of the block of stock to be valued; and
- market price of publicly traded stocks of corporations in the same or similar line of business.

Because valuation discounts are often complex and could have significant financial ramifications, make sure you consult a qualified tax or financial advisor early in the process. Tinovsky Law Firm can help you select a tax or financial advisor that is right for you.

The Business Insider newsletter is provided as a general informational service to clients and friends of Tinovsky Law Firm. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does it create an attorney-client relationship.

*For more information, please contact **Vlad Tinovsky** at vtinovsky@tinovsky.com or **215.568.6862**.*

© 2006 Tinovsky Law Firm. All Rights Reserved.