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SHOULD YOU INCORPORATE YOUR BUSINESS?

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.

Decisionmaking

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.

Making the appropriate choice for a business form is one of the first, and one of the most important, decisions a new business will make. Whether choosing a corporate structure or some other form, make sure to consult with a qualified attorney.

SPORTS INJURIES

Lightning Strikes Golfer

Patrick and his friend Christopher decided to get in some late-afternoon golf on a summer day that had seen periods of turbulent weather, but also some clear skies. As Christopher held the flag for Patrick to putt, a golf course employee sounded a horn to warn of lightning in the area. Patrick putted out to finish the hole. Then the two friends started walking back to the clubhouse, which was about a quarter of a mile away. On their way, they were struck by lightning. Christopher was rendered unconscious for a few moments, but Patrick suffered serious injuries, and he now needs total care.

A negligence suit by Patrick's parents against the golf course owner was unsuccessful. For an owner of property to be liable for injuries to someone on the property, the injury must have been foreseeable. Without that, no duty of care arises in favor of the injured person. Practically everyone knows that lightning is dangerous, but that is quite different from being able to foresee that a particular lightning strike may occur.

Even assuming that the golf course operators owed a duty to Patrick, they did not breach that duty. Patrick and Christopher were given notice that lightning was in the vicinity by means of the horn, which sounded about 10 minutes before the strike that injured Patrick. That would have been enough time to get back to the clubhouse had the boys immediately heeded the warning. Aside from the specific audible warning, a prominent sign at the course warned all golfers that they were playing at their own risk and that when lightning was in the area they were to return to the clubhouse.

The sobering lessons from this case are that golfers themselves bear the most responsibility for protecting themselves from lightning, and that to delay in seeking shelter when lightning is near is to risk a tragic outcome.

Fan Hit by Foul Ball

Practically since our national pastime was in its infancy, operators of baseball stadiums have benefited from a more limited duty to spectators than that which generally applies to businesses that invite the public to come onto their property. Alone among spectator sports, baseball has fans who actively try to catch errant balls, sometimes even risking life and limb to get one. Even if fans would just as soon avoid the batted or thrown balls, the law has assumed that they are aware of the risks from these balls when they take their seats in the stands. The limited duty favoring fans generally is met if seats with protective screening are provided for as many people as normally would want them.

But what of the unsuspecting fan who is clobbered by a foul ball when he has left the sanctuary of his screen-protected seat to get a beer from a vendor? That was the misfortune of a fan who overcame the limited-duty rule when he sued a minor league baseball team for his injuries. A state supreme court ruled that his lawsuit could proceed under ordinary negligence principles.

The limited-duty rule for baseball fans loses its rationale when an injury from a flying ball occurs somewhere other than in the stands. In other areas of a stadium, it is foreseeable and predictable that fans will let down their guard. They may not even be paying attention to the game at such times and places, nor should they have to for their own safety. In the case at hand, when he was struck by the ball, the fan was chatting with other people in the line for concessions, and he could not have seen the batter hit the ball even if he had tried.

The court's concern for fans was heightened by some changes in baseball as a spectator sport. Children and seniors frequently attend professional baseball games. Today's players hit baseballs harder and farther. In keeping with the notion of the sport as multifaceted entertainment, ballparks today present what one observer has called "a sensory overload of distractions." As the court observed, "the beauty of common law is the ability to adapt to the times."

VALUATION DISCOUNTS 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.

THE HAZARDS OF RÉSUMÉ SCREENING

It is popular now for employers to use screening tests, often administered on the Internet, to weed out a large portion of applicants for job openings before making the more difficult selections from among those who survive that first cut. Such tests are supposed to measure cognitive ability, personality characteristics, or, in fewer instances, the ability to perform in a simulation of the duties that the job requires. The easily administered and scored screening tests have their appeal, especially if you are charged with filling, say, 10 positions from 100 people who have submitted résumés.

A downside to screening tests is the risk that rejected applicants may persuade a court that the tests essentially were a tool to accomplish prohibited discrimination, even though that may not have been the employer's intent. For example, an employment test that impacts racial minorities or women disproportionately could lead to liability unless the employer can show that the test is sufficiently related to the job and is necessary to the employer's business.

Another potential pitfall stems from the prohibition in the Americans with Disabilities Act (ADA) against medical testing of job applicants. There sometimes is a fine distinction between acceptable personality or psychological tests and prohibited medical tests. The screening of applicants also could run afoul of some state statutes that protect against invasions of privacy.

When individuals adversely affected by a personality test challenged the test in federal litigation under the ADA, an appellate court struck down the test. The test, at least in some of its 502 questions, was a prohibited examination of the applicants' mental health. Its true or false questions went much farther than the acceptable lines of inquiry about matters such as working well in groups or in a fast-paced office. Instead, they ventured into the realm of psychiatric disorders. In this case, a prospective manager of a rent-to-own store could not be required to give true or false answers to statements such as: "I see things or animals or people around me that others do not see"; "At times I have fits of laughing and crying that I cannot control"; or "My soul sometimes leaves my body."

EMINENT DOMAIN UPDATE

Landowner Loses the Battle but Wins the War

In one of the most controversial eminent domain decisions ever, the United States Supreme Court ruled in 2005 that a city's exercise of its eminent domain powers to take private property in furtherance of an economic development plan satisfied the constitutional requirement that such power be used only for a "public use," even though private developers stood to profit handsomely from the city's actions. In reaction to that ruling, some state legislatures have been busy crafting legislation to limit the use of condemnation powers in such circumstances. For their part, the owners of property targeted for condemnation have considered how they still might fend off the taking, or, failing that, how to maximize the compensation that the government must pay.

In a recent case, a landowner was not able to defeat a condemnation initiated by a city so that a new hotel could be built on the property, but he did receive maximum compensation from an obviously sympathetic jury. The landowner was an immigrant who had spent two years and a lot of money renovating a warehouse and building a mail-order cigar business. When two private developers were unsuccessful in negotiations to buy the property as a site for a hotel, they instead reached an agreement with the city whereby the city would condemn the property for their desired use and the developers would pay the costs and fees associated with the condemnation.

When the city was first attempting to buy the property, it sent the landowner a toxic waste notice requiring him to investigate whether any toxins existed in the ground. The landowner tried to comply, but after spending many thousands of dollars he found no toxins. The city would later admit in the litigation that such an investigation was not really feasible so long as a building remained on the property. The toxic waste notice, and especially its suspicious timing, came to be seen as a tactic to put pressure on the landowner during the negotiations leading up to the condemnation.

Although the trial court ruled that the city could condemn the land for the hotel, in the subsequent trial before a jury for damages, the landowner fared much better. The jury awarded him the entire amount he had sought. The award included several million dollars each for the value of the property itself and for the loss of the goodwill associated with the cigar business. Damages for loss of a business are not typical in condemnation cases, but the landowner was able to show that there was no suitable alternative location for the business, so that he would have to start over from scratch. For good measure, the jury also awarded damages equal to the cost of the dubious toxicity study that the landowner had been forced to undertake.

SMOKE ALARMS: INEXPENSIVE GUARDIAN ANGELS

If you could pay $10 and, in return, get a guard who would warn your family if your house caught fire, would you? Of course you would. Despite this, most people do not have enough smoke detectors in their homes—detectors that will stand guard over your family's lives 24 hours a day. The evidence shows that using even an inexpensive smoke detector increases your family's chance of surviving a house fire by 50%, making it one of the best investments you can make for your family's safety.

Experts recommend installing smoke detectors, the cheapest of which start at about $10, throughout your house. At a minimum, install one detector for every floor and one outside of each bedroom. Test your smoke alarms once a month, and replace the batteries once a year. Make sure that every member of your family knows (1) what to do when the smoke alarm sounds, and (2) the fire escape route from each room. A little advance planning can help make sure that you and your family have a better chance if a fire should start in the night.