

Business Law Notes

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Third in the series regarding employee-owner compensation:

MULTIFACTOR TEST STILL RELEVANT IN DETERMINING REASONABLE COMPENSATION

By F. Stephen Glass

Employee compensation is deductible by the business if it is paid for services rendered and is reasonable in amount. All elements of an employee's compensation package (e.g., salary, bonus, fringe benefits, retirement plan contributions and deferred compensation) are considered in determining the element of "reasonableness." The IRS more often questions the reasonableness of compensation paid to employee-owners since it is less likely that an "arms-length" transaction occurred in setting the compensation.

The IRS usually treats unreasonably high compensation as a *nondeductible* dividend.

The method that most federal court circuits use to determine the reasonableness of the employee-shareholder's compensation is the "multifactor test," e.g., the courts look at all the factors surrounding the compensation that is paid to the shareholder-employee.

A new method is being used in some federal circuits which believe that the relevant inquiry is whether an inactive, independent investor would pay the employee-owner the same compensation. That is, would an outsider set the same compensation?

In a recent 1st Circuit case, however, the court applied the multifactor test to find that paying six-figure salaries to family members whose jobs were answering the phone, signing checks and various other office duties — you guessed it — *unreasonable!!*

Defending the Reasonableness. One or more of the following factors may address an IRS challenge to the reasonableness of an employee/owner's compensation:

- ❑ Compensation packages of similarly situated employees in other companies are comparable.
- ❑ The documented qualification and abilities of a given officer justify a larger compensation package than a similarly situated employee.
- ❑ The time the officer devotes to the business and his/her contribution to the documented success of the business.
- ❑ There is no relationship between the stock owned and the compensation received. Corporations should avoid compensating employee-owners in proportion to their stock ownership since this indicates that at least part of the compensation package represents disguised dividends.
- ❑ The officer is currently receiving greater compensation to make up for prior inadequate compensation.

- ❑ The size and complexity of the company's business operations support the level of compensation.
- ❑ An outsider would pay the employee - owner the same compensation.

The corporation's board should carefully consider these points before setting employee - owner compensation.

Corporate Law Brief:

SOMETIMES YOU HAVE TO SWEAT THE SMALL STUFF

By M. Blen Gee

Sometimes seemingly trivial mistakes can have huge consequences. When it comes to corporate housekeeping and contract management, obsessive-compulsive behavior can be a virtue. Here is a short list of some seemingly trivial details that must be given careful attention.

1. Always use the full corporate name, especially "Inc.," "Company," "Ltd.," "LLC," or similar endings that show the corporate and limited liability character of your company. When signing on behalf of the company, always, always use your title. The safest way to sign is as follows:

FULL COMPANY NAME, INCLUDING "Inc.," "Company," "Ltd.," "LLC," etc.

By: _____

Signature, Title (president, vice-president, manager, etc.)

Business owners can be sued personally for a

corporate debt on the ground that "Inc." was left off the contract and the plaintiff thought it was dealing with an individual doing business under a trade name. These things really do happen, and attention must always be paid to this detail.

2. Make sure that your registered office and/or registered agent and principal office are current on the records of the Secretary of State. Your company must do this in every state that it has an office. If a plaintiff's attorney is unable to find your company, he can serve his lawsuit on the Secretary of State, and you may find that a default judgment has been entered against your company in a suit that you never knew about.

3. The same care should be given to assumed name filings. In N. C., if you are doing business under a trade name, you must file a certificate of assumed name in each county where you maintain a place of business. The requirements in other states vary significantly, and you should consult with local counsel if you have an office in another state.

4. Keep a copy of every contract, ***FRONT AND BACK!*** More than one lawyer has had the unfortunate experience of trying to advise a client about his legal rights without the fine print on the back page of the contract or without a copy of the contract at all. Frequently in equipment lease contracts, service contracts and many other situations, you sign the form agreement and mail it off and never get a copy back signed by the other party.

5. Under N. C. law, corporations must file an annual report with the N.C. Department of Revenue; limited liability companies must file an annual report with the North Carolina Secretary of State. Failure to file the annual report could result in the administrative dissolution of your company. The annual report for a corporation is due on by the fifteenth day of the third month following the close of the corporation's fiscal year, usually March 15; for limited liability companies, it is due on by the fifteenth day of the fourth month following the close of the fiscal year, usually April 15. Forms may be obtained from the N. C. Department of Revenue at 919-733-8510 or the Corporations Division of the North Carolina Secretary of State at 919-807-2225. Other states will have similar requirements.

Bankruptcy Brief:

FILING THAT PROOF OF CLAIM IS IMPORTANT

By Jean Winborne Boyles

So, you receive an envelope from the U.S. Bankruptcy Court, open it and there is this Notice and a form called a "Proof of Claim" on which is the name and address of a person or business that owes you money. Well, you think, the Bankruptcy Court must know that I am a creditor or it would not have sent me this form. I'll receive the dividend on the debt that I am owed, won't I???

When a creditor receives a notice of a bankruptcy, it will usually tell you to file or not file a Proof of Claim and gives a deadline by which to do it. Do not assume that this notice you have received in the mail is just a perfunctory form and that you will get paid money

when the time comes. Read the notice. Know your deadlines.

Depending on how much a creditor is owed, a business decision may be made about how active one wants to be in the bankruptcy. The first things a creditor should do is determine how much money it is owed and if the debt is secured or unsecured. If it is a small amount of money, one may assume that it is not worth worrying about. But I would encourage any creditor to file a proof of claim if he is told to file one. One may be instructed that it is a "no asset Chapter 7 case and no claim shall be filed." If in fact that is what the notice of bankruptcy says, file it away and you will be notified if in fact you need to file a proof of claim at any time. But if you have a secured claim in a Chapter 7, a security is being held for you. Protect your security interest by filing a claim to notify the Trustee.

The services of a bankruptcy attorney can be a smart investment. Trying to navigate the rough waters of bankruptcy can be perilous. Some of the rocks and shoals include knowing what pre-Petition claims, administrative claims and unsecured and secured claims are, and in certain instances, like a claim for rent, what you may claim. If the debt is a significant amount of money and the Proof of Claim is not properly filled out or is not timely filed, or if the claim is not classified appropriately and the appropriate documentation provided, your claim will be denied. The burden is on the creditor to prove his claim, to timely file and be prepared to prove that you did so.

Some pitfalls in bankruptcies include a creditor failing to file a proof of claim (or filing it after the deadline), a landlord incorrectly filed for his damages, not sending appropriate proof, failing to assert a guarantee -- all of which will lead to a denial of your claim. Filing a proof of claim is the equivalent of filing a lawsuit to obtain money owed you. Even the filing of a proof of claim for a mechanics lien in a bankruptcy case qualifies as the filing of a lawsuit to perfect a notice of lien. In short, proofs of claim are important. They are technical, and it may be difficult for a layman to fill it out. A creditor will not receive his dividend if the proof of claim is not accurately and timely filed. Consult an attorney and file your proof of claim if you want to receive a dividend on the debt owed you.

SELLING YOUR BUSINESS - LONG TERM PLANNING

By M. Blen Gee

If you intend to eventually sell your closely held business, some long term planning can substantially reduce problems at the time of sale and increase the money in your pocket. Here are a few planning tips:

√ **Making the "S" election.** Under the current federal tax law, if your corporation is a "C corporation," the profits on the sale of your business will be taxed twice, once at the corporate level and again at the shareholder level. Long term planning is required to avoid this problem. The effect of C corporation earning can continue for ten years after making the S elections. The "double taxation" problem disappears ten years after making the "S" election. Another possibility is to

obtain a formal valuation of your business. Then make the “S” election. The increase in value of your company after you make the “S” election will escape the double tax. Caution is advised, however; making the “S” election can sometimes trigger tax consequences, especially if you rely heavily on LIFO (Last In First Out) accounting and have a large LIFO reserve.

√ **Environmental Audit.** If you are going to sell your real estate along with your business, it may be prudent to have an environmental audit conducted by a reputable environmental firm of your choice. Presenting a recent environmental audit to a perspective buyer can frequently streamline negotiations. Note, however, that any environmental issues found by your consultant will likely have to be reported to authorities and remedial action would be required.

√ **Buy Equipment Rather than Lease.** Arranging for the assumption of equipment leases can frequently be cumbersome and the lessor frequently requires that your company remain secondarily liable on the lease. If you have purchased the equipment and are paying on a promissory note, the note can simply be paid off from closing proceeds and your liability is extinguished.

√ **Minority Owners.** Occasionally a five or ten percent shareholder can be an obstacle to a sale, sometimes demanding more than his fair share in order to approve a sale. A well drafted agreement clarifying the parties’ rights in the event of a sale could greatly streamline the sales process. If the opportunity to buy out the minority owner arises, it may be appropriate to do so. Note, however, that the controlling owners of a company always have a high duty of loyalty and trust to the minority owners in such transactions. For example, if you have an attractive offer to buy your company which you fail to disclose to the minority owner, this could easily lead to an ugly litigation.

√ **Corporate Housekeeping.** It’s the day before the closing and the buyer’s attorney asks to see your corporate minute book. If your stock ledger, minutes, and by-laws are all up-to-date, things will go smoothly. If not, expect delays, especially if you are selling corporate stock instead of corporate assets.

Employment Law Brief:

WHAT ARE GOOD “CAUSES” FOR A “DISMISSAL FOR CAUSE”?

By F. Stephen Glass

Your employee handbook or the employment agreement that your company uses no doubt has a provision that permits the immediate dismissal of an employee “for cause.” But what is a sufficient “cause” for such dismissal?

There are a number of generally accepted circumstances that are sufficient cause for the immediate dismissal of an employee. Some are:

- ▼ Theft, fraud, gambling, carrying a weapon or otherwise violating the law on the employer’s premises.

- ▼ Conviction of crimes involving moral turpitude.
- ▼ Wilful or repeated violations of safety precautions.
- ▼ Falsification of pay or employment records, including employment applications.
- ▼ Exhibiting violence or disorderly conduct towards others in the workplace.
- ▼ Insubordination or refusal to comply with instructions.
- ▼ Drunkenness or illegal use or possession of drugs on the job.
- ▼ Immoral or indecent conduct on the job.
- ▼ Verbal or physical conduct constituting sexual harassment.
- ▼ Engaging in activities that constitute a conflict of interest.
- ▼ Unauthorized use of company material or equipment (computers, autos, etc.).
- ▼ Neglect of duty (e.g., excessive tardiness or absenteeism, sleeping on the job, quitting work before proper time, etc.).
- ▼ Knowingly admitting unauthorized persons to restricted areas.

Immediate documentation of such actions is essential. Consult your legal counsel regarding specific situations that arise in the workplace or to have your contracts and employee handbook updated.

SHOULD YOUR COMPANY HAVE A CELL PHONE USE POLICY?

By F. Stephen Glass

A trend to sue the employer is emerging when a traffic accident is caused by employee work-related cell phone use. Studies have shown that the risk of collision is **four times higher** during cell phone use!

Among the cases of interest is a Virginia case where the judge ruled that a man could pursue his \$30 million lawsuit against a lawyer and her law firm, alleging her use of a cell phone while driving on the job caused her to run down and kill his 15-year old daughter.

If any of your employees drive as a part of the job, it would be prudent for your company to have a policy that prohibit the use of a cell phone while operating a vehicle — especially the company vehicle -- on the job. Employers who adopt and enforce such a policy will reduce the risk of liability to the employee as well as the company.

➔ About the authors:

M. Blen Gee, Jr., is an honors graduate of the University of North Carolina School of Law. His areas of concentration include business and corporate law, including sales of businesses; business litigation, including arbitration and mediation; franchise law; automobile dealer law; and insurance company insolvency.

F. Stephen Glass is the author of *The Legal Handbook for North Carolina Businesses*, and *Your Estate Planning Handbook*. His practice is concentrated in the areas of business, employment and corporate law, business litigation, business succession planning and estate planning. He serves on the Cary board of Capital Bank.

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On September 3, 2003, Samuel H. Johnson, founder and senior member of our firm, will celebrate fifty years of a most distinguished law practice.

Sam Johnson was born September 13, 1927 in Sampson County, N.C. He attended Pfeiffer College and following service in the Navy at the Naval Research Laboratory (1946-1948), he attended Mexico City College and graduated from the University of North Carolina (A.B.) In 1950, and the U.N.C. School of Law (J.D.) He was admitted to the N.C. bar on September 3, 1953. He is admitted to practice in the U.S. District Court, Eastern District of N.C. and U.S. Supreme Court.

He served in the N.C. House of Representatives from 1965 to 1974. He has also served as a Trustee, University of North Carolina, 1967-1972; Chairman, N. C. Local Government Study Commission, 1967-1973. N.C. Joint Select Commission on Fiscal Trends and Reform, 1992-1993; Advisory Budget Commission of N.C., 1969-1971; and Special Counsel to Speaker of House of Representatives and Lt. Governor, 1975-1977.

Mr. Johnson's professional and civic memberships and accomplishments are too numerous to mention here. He was a general practitioner in the early part of his career; his current practice areas are legislative practice; estate Planning; business law; and trade association law.