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A NEWSLETTER FOCUSING ON PLANNING FOR THE SMALL BUSINESS

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RESOLVING POTENTIAL CONFLICT IN CLOSELY HELD COMPANY

Susan and Larry Herbert joined with Janice Porter to form Professional Restaffing of Ohio, Inc. (PRO) with Porter owning 50% of the stock, and each of the Herberts 25%. Shortly after formation, the shareholders elected Susan Herbert, Janice Porter and Porter's husband, Joseph, directors who established a compensation structure by director resolution. The company continued to operate for 15 years and by all accounts was profitable. At some point, the Herberts become dissatisfied with the compensation structure which could only be changed by another director resolution. But since the board was controlled by the Porters, the Herberts could only change the compensation structure by changing the makeup of the board which they could do if Larry Herbert was elected to replace Joseph Porter as a director. But because of the equal shareholder voting power of the Herberts and the Porters, the Board and the compensation structure remained unchanged.

At a shareholder meeting, Susan Herbert and Janice Porter were both elected directors but the shareholders could not agree on the third director - the Herberts voted their 50% for Larry Herbert and Janice Porter voted her 50% for Joseph Porter. The Herberts filed suit to have PRO judicially dissolved which they won because of the shareholder deadlock.

Porter countersued claiming that the Herberts breached their fiduciary duty to her by calling for an election that resulted in the deadlock causing the dissolution. She lost on her claim for damages for the clients she lost to the Herberts after the dissolution but the jury returned a verdict of $715,400 in damages against the Herberts for breach of fiduciary duty. The Herberts appealed.

By way of background, shareholders in a close corporation, i.e., one with few shareholders whose corporate shares are not traded on a securities market, owe each other a fiduciary duty to deal in utmost good faith which is heightened to prevent majority shareholders from using their control to deny minority shareholders an equal opportunity in the corporation. Majority shareholders can deny minority shareholders a share of the profit, prevent dividends, grant exorbitant salaries or bonuses to the majority, or lease property owned by majority to the corporation at high rates. Minority shareholders generally cannot sell their stock since there is no market for a minority position. But the court of appeals held that there was no breach of fiduciary duty, which exists to protect minority shareholders, because Porter had 50%.

Nor was Porter entitled to damages for lost clients because this was a claim for loss of <u>future</u> profits and this was not a form of damages available after a judicial dissolution.

The legal problem in this case arose at the outset when the equal shareholders voted a corporate resolution electing an unequal board of directors. This set up the two to one voting power of the Porters to control the compensation and management to the detriment of the Herberts.

This teaches an important lesson in business formation. Always seek competent legal, accounting, and business advice from disinterested professionals experienced in their fields when establishing a new business. A simple agreement of a few words would have avoided this expensive, time consuming and senseless small business disaster.

ADVANCES TO BUSINESS - DEDUCTIBLE OR NOT?

Is it debt or is it equity? If shareholders advance money to their business as loans, the corporation can deduct the interest it pays. If the advances are equity, payments are constructive dividends and are not deductible. The IRS and the courts have gone round and round on this issue. In a recent decision, the Sixth Circuit Court of Appeals sitting in Cincinnati held that shareholder advances were bonafide debt, not equity, so the corporation could deduct payments as interest.

In this case, the majority of stock of the company involved was owned by a parent whose children held the remaining shares. The stockholders periodically advanced funds to the business on which the corporation paid interest of 10%. Initially the loans were not documented but beginning in 1993, promissory notes were executed for the outstanding amounts. The advances ranged between $600,000 and $1.7 million and the corporation paid $45,000 to $175,000 in interest each year.

This case began in the tax court which weighed the factors for loan and those for equity. It decided for equity but the Sixth Circuit said no.

It is important for small businesses to know what the Sixth Circuit determined to be the eleven factors for deciding the debt/equity issue:

- The name given to the debt instrument
- Presence of a fixed maturity date and schedule of payments
- Presence of a fixed rate of interest and interest payments
- Source of repayments
- Adequacy of capitalization
- Identity of interest between the creditor and stockholder
- Security
- The company's ability to obtain financing from outside lending institutions
- Whether claims were subordinated to outside creditors
- Extent to which funds were used to acquire assets
- Presence of a sinking fund to provide repayments.

The Sixth Circuit ultimately decided that two factors favored equity and nine favored interest, especially noting the presence of -

- A fixed and reasonable interest rate
- Issuance of notes
- Notes were payable on demand and the fact there was no fixed maturity date was not problematic to the court
- Repayment of funds borrowed from a bank to repay as opposed to repayment contingent on profit
- Use as working capital rather than purchase of assets;

Carefully structuring advances to the business by means of well-drafted corporate resolutions, documents, accounting records, and business-like treatment of payments will assure a predictable result and avoid costly litigation.

CREDIT FOR LONG DISTANCE EXCISE TAX FOR THREE YEARS

If you were billed between March 1, 2003 and July 31, 2006 for federal telephone excise tax on long distance or bundled service, you may be able to request a credit for the tax paid. You had bundled service if your local and long distance service was provided under a plan that does not separately state the charge for local service. You can request the standard amount or the actual amount you paid. The standard amount is $30.00 or $40.00 depending on filing status. If you believe you paid more than the standard amount, it can be of benefit to request the actual amount. If you request the actual amount paid, you must attach Form 8913 showing the amount paid and keep records to substantiate the amount. If you request the standard amount and later want to change it to the actual amount, you must file an amended return. If you request the standard amount, you do not have to include the credit in income for any tax year.

If you do not file an individual income tax return but you paid federal telephone excise tax on long distance or bundled telephone service during the specified time and you have not received or requested a credit or refund of the federal excise tax from your telephone service provider, you can file form 1040ez-T to obtain a refund.

FRAUD ON THE INTERNET INVOLVES BOGUS IRS EMAILS AND WEB SITES

The IRS has issued several recent consumer warnings on the fraudulent use of the IRS name or logo to gain access to personal information in order to steal an individual's identity and assets. This is generally known as phishing.

Current scams include emails which claim to come from the IRS telling the recipient that they are due a refund. The information obtained is then used to steal financial accounts, make credit card purchases, apply for loans, credit cards, services or benefits and even file fraudulent tax returns. A person whose identity is stolen may have to spend months or longer cleaning up his credit and name and, while doing so, suffer loss of job opportunities, loans, housing, or even arrests for crimes he didn't commit.

A number of bogus web sites in over twenty countries have been unearthed. One bogus email claiming to come from *"tax-refunds@irs.gov"* tells the recipient he is eligible for a refund of a certain amount but he must access a form though a link contained in the email which asks for personal and financial information.

Another bogus IRS letter and form *"W-8BEN"* asks non-residents to provide personal information such as account numbers, PINs, mother's maiden name and passport number. The legitimate IRS form W-8BEN, which is used by financial institutions to establish appropriate tax withholding for foreign individuals, does not ask for any of this information.

The IRS does not ask for personal identifying or financial information via unsolicited e-mail and no form is needed to obtain a refund.

If you receive a suspicious e-mail purporting to be from the IRS:

- Do not open any attachments in case they contain a malicious code to infect your computer; and
- Contact the IRS at 800.829.1040 to determine whether the IRS is trying to contact you.

PROPERTY LEFT FOR SERVICES IS DAMAGED: WHO'S LIABLE?

Carol Preston took her handmade Amish quilt to Royal Custom Cleaners for dry cleaning. She informed Royal that the quilt was handmade and inquired whether they could clean it and was assured that they could. Peter Hartman, the owner, tested areas of the quilt with paint, oil and grease remover to check for potential bleeding and then placed the quilt in the dry cleaning machine. As soon as perchloroethylene came in contact, the dyes immediately began to bleed. Hartman returned the quilt to Preston but refused to take any responsibility for damages. Preston sued and testified that she used the quilt on special occasions for aesthetic purposes and in its damaged condition no longer had any value. Hartman said it was the fault of the Amish maker for failing to put a care label in violation of federal law and FTC regulations.

Like some other businesses, a dry cleaner is a "bailee for hire" and must use ordinary care in the treatment of the bailor's property. As part of the bailment contract, the bailee promises to return the bailor's property in undamaged condition. The court was not persuaded by the defense that the maker violated federal law and Preston was awarded the $400 purchase price

Some bailments benefit the bailor such as keeping a friend's car when he goes out of town. Some benefit the bailee such as lending a car to a friend. But more commonly, bailments are mutually beneficial, for example, parking lots which provide parking for a fee.

Bailees must take care to protect the property, use the property as agreed, return the property to the owner, and make repairs or service in a workmanlike manner. The bailor must compensate as agreed and advise of all defects.

The standard of care for ordinary bailments is simple negligence, that is, the bailee must use ordinary care to protect the goods. But some bailees have a higher standard: common carriers like bus or train companies, warehouse companies, and hotels.

Think about all those signs you see in various businesses including parking lots or mechanic's garages which state: " not liable for damages." Maybe you do not want to leave your car or other property there.

DANIEL H. MCKINNEY AGAIN NAMED CINCINNATI SUPER LAWYER BY LAW AND POLITICS AND THE CINCINNATI MAGAZINE

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