THE BASICS
OF
MAINTAINING YOUR CORPORATION

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Thank you for allowing our firm to assist you in setting up and organizing your corporation. The following is basic information you need to assure that your corporation stays in good standing and is legally entitled to do business in California.

Employer Identification Number (EIN)

We have obtained the Employer Identification Number shown on the cover page for you.

Every corporation filing a state or federal tax or informational return must have an employer identification number (an "EIN"). An EIN is your company's "social security number" and it is used by banks and other companies as an identification number.

Bank Accounts

The corporation must have its own bank account into which all income must be deposited and expenses paid. The checks should be printed with the full corporate name and any trade name it is using. To open this account you usually only need a copy of the Articles of Incorporation and your EIN. Since the passing of the Patriot Act, there are additional regulations which may require the bank to request additional information or documents. If your bank needs something else, such as a Secretary's Certificate or similar document, we will draft this for you.

Piercing the Corporate Veil and Alter Ego Liability

As such, corporations just began being viable business entities in the late 1880's. Prior to that time, Business Trusts, Partnerships and other Associations were used by businesses to protect their assets and members. Corporations are the product of legislation that is intended to protect people who invest in business and whose assets would be subject to liability if the investment fails.

The corporate structure will generally protect the assets of the shareholders from the liabilities and debts of the corporation. However, this is so only where the corporation is treated like a separate entity (distinct from its owners) and observes the corporate formalities required by law. If you fail to do so, a creditor may be able to ignore the corporation and pursue the individual shareholders' assets in order to satisfy the debts and obligations of the corporation. This is called "piercing the corporate veil." When the corporate veil is pierced or disregarded, then the shareholders are saddled with the liability for its debts and obligations. This type of liability is routinely called "alter ego liability." In other words, the law will impose liability against the shareholders because there is no separateness between them and the corporation. Obviously, this would be a bad result for the shareholders.

In order to avoid these negative consequences, the corporation should keep in mind the following points:

1. Corporate Records

It is important that you maintain your corporate records in a professional manner, and in a way which complies with the California Corporation's Code. Failure to do so is one of the key factors courts will look to when considering whether or not to pierce the corporate veil.

Specifically, the corporation is required to hold annual meetings of the shareholders and annual meetings of the Board of Directors. These can be actual meetings with the required quorum, or they can be held "on paper." What this means is that a document called a "Unanimous Written Consent in Lieu of Meeting" is drafted and executed by all persons who are required to be at that meeting.

Additionally, any extraordinary transactions must similarly be documented, and would be done so at a "Special Meeting" of the shareholders or directors (depending upon the specific facts of each transaction).

Once these meetings are held, the minutes or written consents should be placed into the appropriate place in your corporate book and maintained there for the life of the corporation.

During the first year of your founding, we will hold four (4) Board of Directors meetings at our office to assist you in maintaining your records. This is included in our fees for establishing your corporation.

2. Adequate Capitalization

The shareholders must invest in the company an adequate amount of capital for the nature of the company's business. They cannot simply lend the company the money. In the case where the company is not adequately capitalized, a court may permit a creditor to look through the company and hold the owners liable for the company's obligation. Courts have held that inadequately capitalized companies can be considered to be shams.

3. Maintaining Corporate Identity

In addition to the issues discussed above, there are a number of steps which you should take to preserve the corporation's identity separate from its owners. These include: not using the corporation's assets as if they were the assets of the shareholders; executing documents as an officer of the corporation ("President" or Secretary"); placing the corporation's income into the corporation's account; not commingling the personal assets of the shareholders with the corporation's assets; and using the full name of the company, including the designation "Inc."

4. Personal Guaranty

Many lending institutions and other business entities will request that shareholders sign “personal guarantees” for loans and obligations entered into by the corporation. Signing a personal guaranty will remove all protection that the corporation provides to the shareholder. This should only be done after careful consideration and discussion with legal counsel.

The Annual Obligations

In addition to the annual meeting of shareholders and annual meeting of directors discussed above, a corporation is required to file tax returns with both the State and Federal governments. Also, the Secretary of State will send to you a "Statement of Information" form which needs to be completed and mailed in. The first such statement is usually filed by the incorporating attorney as part of the incorporation process.

S Corporations

S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes. Shareholders of S-Corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S-Corporations to avoid double taxation on the corporate income. S-Corporations are responsible for tax on certain built-in gains and passive income.

To qualify for S-Corporation status, the corporation must meet the following requirements:

- Be a domestic corporation.
- Have only allowable shareholders including individuals, certain trust, and estates and may not include partnerships, corporations or non-resident alien shareholders.
- Have no more than 100 shareholders.
- Have one class of stock.
- Not be an ineligible corporation, i.e., certain financial institutions, insurance companies, and domestic international sales corporations.

In order to become an S-Corporation, the corporation must submit Form 2553 Election by a Small Business Corporation (PDF) signed by all the shareholders.

Misleading and Fraudulent Solicitation Letters

The Secretary of State's office has been advised that solicitation letters are being sent to California businesses encouraging them to comply with their California Corporations Code filing obligations by submitting fees and documents to a third party rather than by filing directly with the Secretary of State's office.

This solicitation may appear to be from the Secretary of State or other official organization. These solicitations are not being made by the California Secretary of State's office and are not being made by or on behalf of any governmental entity. Although a business entity can use an intermediary to submit filings and fees to our office, no business is required to go through another company in order to file its documents with the Secretary of State's office.

Our firm will make any filing required on your behalf. Please contact us if you receive this type of solicitation.

Annual Franchise Tax

Minimum Franchise Tax

All corporations subject to the franchise tax, including banks, financial corporations, corporate general partners of partnerships, and corporate members of LLCs doing business in California, must file Form 100 and pay at least the minimum franchise tax as required by law. The minimum franchise tax, as indicated below, must be paid whether the corporation is active, inactive, operates at a loss, or files a return for a short period of less than 12 months.

- Domestic qualified inactive gold or quicksilver mining corporations: $25.00
- All other corporations subject to franchise tax (see General Information A, Franchise or Income Tax, for definitions): $800.00

A combined group filing a single return must pay at least the minimum franchise tax for each corporation in the group that is subject to franchise tax.

For corporations incorporated or qualified through the California SOS to do business in California on or after January 1, 2000, the prepayment of the minimum franchise tax to the California SOS is no longer required. For the first taxable year, the corporation will not be subject to the minimum franchise tax and will compute its tax liability by multiplying its state net income by the appropriate tax rate. The corporation will become subject to minimum franchise tax beginning in its second

Form 100, Booklet 2012, Page 7, taxable year. This does not apply to corporations that are not qualified by the California SOS, or reorganize solely to avoid payment of their minimum franchise tax.

There is no minimum franchise tax for the following entities:

- Corporations that are not incorporated in California, not qualified under the laws of California, or are not doing business in California even though they derive income from California sources. However, if corporations meet the sale, property, or payroll threshold for "doing business" under R&TC Section 23101(b), corporations may be subject to the minimum franchise tax. For more information regarding "doing business", see General Information A, Franchise or Income Tax; refer to R&TC Section 23101(b); get FTB Pub. 1050, Application and Interpretation of Public Law 86-272; or FTB Pub. 1060, Guide for Corporations Starting Business in California.

- Qualified non-profit farm cooperative associations.

- Credit Unions.

- Exempt homeowners' associations.

- Unincorporated homeowners' associations.

- Exempt political organizations.

- Exempt organizations.

- Corporations that are not incorporated under the laws of California; whose sole activities in this state are engaging in convention and trade show activities for seven or fewer days during the taxable year; and that do not derive more than $10,000 of gross income reportable to California during the taxable year. These corporations are not "doing business" in California.

  For more information, get FTB Pub. 1060.

- Newly formed or qualified corporations filing an initial return for a taxable year beginning on or after January 1, 2000.

Business Buyout Agreement

A business buy-sell agreement--sometimes called a buyout or partner buyout agreement--is vital to any small business that has more than one owner. And that includes family businesses. This is not about buying and selling businesses. Rather, it is an agreement between partners or co-owners governing these basic things:

1. When – and under what conditions – a partner or co-owner can sell his or her interest in the business.

2. Who will be allowed to buy into the business?

3. Circumstances that would require a co-owner to sell.

4. How the price of an owner's interest will be determined.

Think of it as a kind of pre-nuptial agreement for business owners. There are too many uncertainties to leave this to chance, including death, divorce, retirement, bankruptcy, misconduct and just plain disinterest in the business that can happen over time.

But while the causes are many, the results are predictable. Without this agreement, an owner's exit can be rancorous and disruptive, perhaps at a time when the business can least afford the headache. The agreement provides for a variety of issues:

- What if a partner gets divorced and her ex-husband, who gained part ownership in the settlement, causes trouble?

- What if a co-owner demands to be bought out at an unreasonable price?

- What if an owner develops a substance abuse problem goes bankrupt and your new co-owner is one of his creditors?

The process of working out a buy-sell agreement can even strengthen a business from the outset, as partners better understand the possibilities and each other.

Funding of the buyout is very important. Just because an agreement calls for a partner buyout doesn't mean the money will be available. "Key person" life and disability insurance can help. Or the agreement might allow installments over a period of years.

Your agreement should include a right of first refusal that prevents departing partners from selling without first offering their interest to remaining owners. This is one way to control who is allowed to own an interest in the company. It will prevent unwanted outsiders from buying in, and allows the business to buy a deceased owner's interest rather than allow inheritors to move in.

The topic of ownership vs. employment is also important. For example, what if an active partner wants to stop working day-to-day in the business, but still wants to remain an owner? Is this allowed? Your buy-sell agreement can address this issue.

While setting a price on the shares can be exceedingly difficult, you can certainly include a formula for setting the price as part of the agreement.

There are three basic buyout agreement types:

1. In a "cross-purchase" agreement, a departing owner sells directly to remaining owners. This works best for partnerships, LLCs or S-Corporations, with no more than a half-dozen or so owners.

2 In "Stock redemption" or "entity-purchase" agreements, the business itself buys back the departing owner's interest and retires the shares. Thus, each remaining owner's interest becomes more valuable.

3. "Hybrid" agreements combine elements of both.

Once you have an agreement in place, review it regularly. Circumstances will undoubtedly change, and your agreement must change too. Pay special attention to the valuation formula. Having the business appraised every few years will maintain a market value of the shares or interest in the business.

Please contact me if you think this type of agreement will be beneficial to you.

Thank you for allowing us to be of service to you and we look forward to working with you over the coming years.

Sincerely,

Vaughn Law Offices
Michael E. Vaughn