

## **FORMING AND CAPITALIZING THE CORPORATION**

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Where the corporate form has been selected as the appropriate vehicle for a new business venture, the owners will next need to make decisions concerning the structure of the business. Each decision will effect the future operation of the new corporation.

Important to the new owner is how the business will be capitalized. Whether to use multiple classes of stock and how to balance the business' debt to equity are crucial decisions with far reaching consequences for efficient and profitable business management. Additional factors considered when forming and capitalizing a corporation include the organization of a possible tax-free incorporation, the transfer of assets and liabilities, the determination of a basis in stock and assets transferred, the possible desire to avoid tax-free treatment, the capital structure's design, including debt-equity considerations, and the organizational and start-up expenses incurred by the corporation in making and executing these decisions.

Typically, a corporation is formed via a tax-free incorporation which occurs when one or more persons hold at least 80% of the corporation's stock immediately after they transfer cash and property to the corporation solely in exchange for stock. By meeting this prerequisite, the owners of the newly formed corporation can transfer assets to the corporation for stock without immediately recognizing any gain or loss on the exchange. What is produced is a tax deferral. The corporation carries over the transferor's basis as its basis for the assets it receives. At the same time, the shareholder's basis for the stock received is the basis in the assets transferred to the corporation. Thus, no gain or loss is recognized at the time of transfer. However, upon the sale of such stock the shareholder must recognize any gain or loss at that time.

As a tax-free treatment may be undesirable in some circumstances, the shareholder may wish to actually recognize gains and losses and treat the transfer of the property as a taxable event. Where the exchange of property does not meet the prerequisites mentioned above, it will be treated as a taxable sale. The corporation will receive a higher basis in the purchased property which is equal to the fair market value of the property as opposed to the transferor's basis. The transferor will recognize the gain and thereby "buys" a stepped-up basis for the corporation.

Along with the incorporation transaction itself, the design of the capital structure is an important concern for the new corporation and its shareholders. The two principal issues raised are whether the corporation should use more than one class of stock and what mix of stock (equity) and debt is desirable.

In developing the capital structure, the owners of a closely held corporation are free to employ several classes of stock. There can be different classes of common stock with different rights to corporate earning and assets. There can be voting and nonvoting common stock. The shareholders may decide to include preferred stock, which also may or may not have voting rights.

Preferred stock has a claim on corporate earnings superior to that of common stock. It demands a fixed dividend that must be paid before earnings can be distributed to the common shareholder. In the event the corporation is liquidated, the preferred shareholders must be paid off before corporate assets can be distributed to the common shareholders. Remember, that an S corporation cannot issue preferred stock without destroying the S election. As an S corporation can have only one class of stock, all shares must have the same rights to corporate profits and assets. An S corporation can, however, have shares with disparate voting rights, such as voting and nonvoting stock.

A corporation is not entitled to a tax deduction for the dividends it pays on either its common or its preferred stock. In contrast, any interest that is paid by the corporation on a loan is fully deductible. Therefore, a corporation will often choose to borrow additional funds from its shareholders instead of having them contribute capital via purchasing preferred stock. The shareholder benefits as well, as the corporation's repayments of loan principal are not taxable to the lender-shareholder. However, if the shareholder's preferred stock is redeemed, the money or property received will most likely be taxed as a dividend.

A great concern of the owner of a closely held corporation is the design and maintenance of a capital structure in which the loans from the owners to the business are classified as debt and not as additional stock or other equity. The classification of purported debt as additional stock or equity can have a significant and typically adverse tax consequence to both the corporation and its shareholders. Because of this, the corporation and its shareholders may experience a debt-equity dispute where they are setting forth criteria in favor of a debt classification.

Too high of a debt-equity ratio will result in a thinly capitalized corporation which may raise a red flag to the Internal Revenue Service. The willingness of the IRS to accept a given debt-equity ratio is affected by the particular industry in which the corporation conducts its business. The IRS typically permits a higher ratio where the industry is stable and earnings are predictable as compared to insisting on a lower ratio for a corporation engaged in a speculative or seasonal business. This reasoning is based on the fact that an independent creditor is less likely to advance funds to a company in the latter category.

As organizational and start-up expenses are a fact of entrepreneurial life, their tax treatment or the ability to take a tax deduction for such expenses is a key concern at the corporation's outset. As these expenses can not be deducted or "written off" entirely in the year they are incurred, they must be amortized over a period of not less than 60 months. A formal election to amortize organizational and start-up costs must be attached to the corporation's tax return for the taxable year in which the corporation conducts an active business.

Organizational costs typically include legal fees for the formation of the corporation, fees paid to the state to incorporate the business, and costs associated with organizational meetings. Start-up expenses include costs incurred in connection with the investigation and creation of an active business as well as pre-opening expenses such as

advertising costs, employee training costs, bank and loan commitment fees, and rent paid before the business begins.

Look for our article titled "Financial Planning Considerations for the Business Owner".