

# Corporate Survival Guide

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# Corporate Survival Guide

## Table of Contents

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<b>Introduction .....</b>	<b>1</b>
<b>Overview - Maintaining Corporate Identity .....</b>	<b>2</b>
<b>Documenting Transfers.....</b>	<b>5</b>
<b>Issuing Shares.....</b>	<b>6</b>
Loans To The Corporation vs. Equity Contributions.....	6
Security Agreements.....	7
<b>Post-Incorporation Federal Tax Issues .....</b>	<b>8</b>
Initial Filings .....	8
The Tax Year .....	8
Accounting Method .....	9
Inventory Method .....	9
The "S" Election .....	9
Amortizing Syndication & Startup Costs.....	10
<b>Federal Tax Planning.....</b>	<b>11</b>
<b>Post-Incorporation State Tax Issues.....</b>	<b>14</b>
State Limitations On Federal Elections .....	14
Apportionment of Income.....	15
<b>Shareholders' Meetings .....</b>	<b>16</b>
<b>Directors' Meetings &amp; All Authority .....</b>	<b>17</b>
<b>Officers' Duties &amp; Authority .....</b>	<b>18</b>
<b>Corporate Records &amp; Shareholder Information .....</b>	<b>19</b>
Other Recordkeeping Duties .....	19
<b>Intellectual Property Issues.....</b>	<b>21</b>
Trademarks .....	21
Trade Name.....	21

**CORPORATE SURVIVAL GUIDE**

Trade Secrets .....	21
Copyright Ownership .....	22
<b>Securities Law Issues .....</b>	<b>25</b>
Registration .....	25
Notices .....	25
Disclosure.....	25
<b>Qualification To Do Business .....</b>	<b>26</b>
<b>Shareholder Agreements.....</b>	<b>27</b>
Buy-Sell Agreements.....	27
Voting Trusts .....	27
Shareholder Agreements.....	27
<b>Appendix A - Estimated Record Retention Guide .....</b>	<b>28</b>

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# Introduction

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You formed a corporation to give yourself and your business associates certain benefits. To ensure that you get the benefits, however, incorporating is just the first step. This guide gives you information about what may have to happen after the incorporation, both at the time you begin the operation and on an ongoing basis. Failing to follow through and maintain the corporation as a separate entity may mean that you and your business associates will not be able to enjoy the benefits you created the corporation to get.

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## Overview - Maintaining Corporate Identity

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You pay good money to buy the protections corporate status provides. To be sure those protections are there when you need them, you have to treat a corporation properly. A corporation needs to be treated as a separate entity for the shareholders to properly avoid potential business liabilities and tax problems. Many important "arms' length" indicia evaluated by court cases and the IRS include the items discussed below.

- Maintaining the existence of the corporation by filing annual reports with the Secretary of State.
- Operating the business of the corporation under its proper name, or under one or more duly filed fictitious names.
- Making sure third parties dealing with the corporation are aware it is a corporation, and are dealing with the corporate name or properly registered fictitious name.
- Making sure that fictitious names are registered.
- Not giving personal guarantees or having personal involvement in situations that would result in personal liability. Any document signed for the corporation should clearly show that the person signing is doing so as an officer without personal guarantees. Read the agreement carefully to be sure there is no small print making the signing officer personally liable. The proper way to sign something for a corporation is:

MARY'S CORPORATION

By:

MARY SMITH, PRESIDENT

- Certain types of agreements, especially agreements with related parties, need to be properly recorded in corporate minute books. One special area of weakness is simply signing the corporate resolutions form a bank gives you to open a corporate account without actually creating the corporate minute book documentation authorizing those votes.

- Treating the corporation as a separate financial entity is important. The corporate checkbook should not be your personal checkbook. Payments to and from the corporation need to be properly documented as loans, capital contributions, compensation, or dividend distributions. These transactions must be properly recorded in the corporate minutes to ensure proper tax treatment or you may pay more tax than you need to.
- Items purchased by the corporation for resale should have the invoice list the corporation as the buyer to avoid potential personal products liability claims.
- Think twice about letting employees drive your personally owned vehicles. If your name is on the title of a car, you have potential liability for anything that car does while someone else drives it. Make sure your commercial insurance package includes unowned automobile coverage to cover potential liability from errands that might be run in an employee or contractor's personal automobile. If you tell the IRS that a car is owned by the corporation while telling the insurance company it is owned personally, there may be a question whether there will be adequate insurance coverage if the car is in a wreck and is actually owned by the company.
- If a company owes money to shareholders or related parties, document this with a promissory note and give the individuals a filed security interest lien or mortgage on corporate assets (if you can) so the individual will be paid before any third-party creditors. These transactions need to be authorized by appropriate corporate minutes to document the proper tax effect and priority.
- Corporate pension plans require extensive periodic updates and proper IRS filings to maintain the creditor-proof status and income tax advantages accorded to certain pension plans. Again, simply signing the corporate resolutions form the plan administrator gives you without actually creating the corporate minute book documentation authorizing those votes can create big problems later.
- In small, closely held corporations, the corporation's CPA should tell the attorney for the corporation about anything that needs to be documented in the corporate minute book for tax and authorization purposes at least annually. This normally includes salary payments made to shareholders, shareholder loans, capital contributions, and any significant capital transactions. Corporate minutes do not have to be complicated, but the IRS and creditors will usually look at the corporate minute book when tax or liability issues come up. In larger corporations, these votes should be recorded at the time the transaction is done.

- If a corporation is not a subchapter S corporation, employee shareholders should usually have an employment agreement entitling their estates or successors to be paid compensation in case of death or disability. Otherwise, the IRS can deny deductibility of payments made after death or disability.
- Arms-length written leases with appropriate authorization should usually be in place. Rent payments need to comply with the terms of the lease, or the IRS may argue those excess payments above what is owed under a written document are not deductible.
- Annual corporate documentation beyond filing a report with the Secretary of State, including appropriate annual corporate actions like electing directors and officers, is essential.
- If you operate in more than one state, authorization to operate as a foreign corporation is important or you may lose the right to easily enforce contracts and may accrue personal liability by officers for taxes.
- If there is more than one corporation, you must be careful that applicable formalities and documentation do not make these corporations parents that would be jointly and severally liable, or that inter-company transfers or financial arrangements do not become tax problems. If one corporation is acting for another, written documentation of the authority to do that must be in place or personal liability may accrue.

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## Documenting Transfers

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Transfers, leases, and contract assignments must be documented along with any assumption of liability. If a prior business transfers into the new corporation, the new corporation should adopt any existing fringe benefits and qualified plans or the ability to deduct payments on them may be denied. The plans may need to be amended.

The assignment of liabilities, particularly secured debt, to a new corporation may require approval. Although vendors will generally not be a problem, bank loans and leases will generally require approval before assignment. Failure to get these approvals may result in accelerating the sums due under the contracts. A useful tool is a blanket assignment of all rights and liabilities to the corporation, subject to any required approvals.

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## Issuing Shares

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Shares are generally issued as a part of the organizational meeting after value is paid for them. That procedure can involve:

- 1 A potential shareholder delivers a subscription agreement asking for the purchase of shares. The offer is generally irrevocable for some time.
- 2 The subscription agreement is agreed to by the corporation.
- 3 If full, agreed-upon consideration is not paid for the shares, the corporation or its creditors can seek recovery of the shortfall from the shareholder. The corporation should keep proof that each shareholder fully paid for his or her shares.

### **Loans to the Corporation vs. Equity Contributions**

The incorporators of a business often must decide whether to treat some initial contributions as debt instead of stock. Among the principal considerations are:

- 1 If the corporation is undercapitalized, creditors could pierce the corporate veil;
- 2 Repayment of debt may be tax-free to the recipient. Repayment of equity may result in taxable income to the recipient;
- 3 If the business fails, loans by shareholders are more likely to be treated as short term capital losses. If stock qualifies for Internal Revenue Code § 1244 treatment, stock losses, up to a certain amount, will be given ordinary loss treatment;
- 4 If the corporation fails with assets, the debt holders have priority to assets;
- 5 If the debt-equity ratio is disproportionate the IRS may treat debt as a second class of stock. This can result the automatic cancellation of any S corporation election;

- 6 Payment of interest on debt is deductible by the corporation. Payment of dividends is not generally deductible;
- 7 If the corporation grows in value, the appreciation benefits shareholders. Creditors generally do not participate in the appreciation; and
- 8 Debt holders are not entitled to vote on corporate matters.

## **Security Agreements**

If loans are made by shareholders or their families to a corporation, review the possibility of securing the debt by assets of the corporation. If the corporation's business subsequently ends, the secured creditors may be in a better position for recovery of their investment. However, the bankruptcy court may limit the rights of shareholder creditors, especially if the corporation was undercapitalized.

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## Post-Incorporation Federal Tax Issues

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### Initial Filings

Every new corporation must apply for a Federal Employer Identification Number ("FEIN"). The application, IRS Form SS4, must be filed with the local IRS Service Center. The FEIN is used in most federal and state tax filings and is usually required to establish an account with any financial institution. Form SS4 also contains several questions about the new business's activities, such as anticipated date of having employees.

Although Form SS4 requests information about the corporation's year end, IRS regulations say that the choice of year end is made on the first tax return filed for the new corporation. To avoid inconsistencies, note "to be determined" in the blank for year end. An officer of the corporation can apply for the FEIN over the phone.

### The Tax Year

Most regular corporations can elect any fiscal year they want. The tax year is selected on the entity's first income tax return. In general, S corporations and professional service corporations must use a calendar year. If either type of corporation can show a valid business purpose for using a different fiscal year, the IRS may allow the use of a different fiscal year. As a requirement of adopting a fiscal year, the corporation must make certain distributions before the end of the calendar year. Generally, once the accounting period is selected, it can only be changed with IRS permission.

Among the factors a C corporation should consider in choosing a year end are the: (1) natural business year of the corporation; and (2) possible advantage of initial year income deferrals. Be sure the tax year selected in the corporate documents is the tax year reflected on the tax returns.

## Accounting Method

The Internal Revenue Code provides that the corporation chooses its tax method with the first tax return it files. Generally, the business must report its income using the method regularly used in keeping its books. For most businesses, the choice is between the cash or accrual method.

The Code is extremely complicated in the methods and approaches for selecting the corporation's accounting methods. The use of the cash method by a regular corporation is restricted if its gross income exceeds \$5 million or if the corporation has an inventory of goods in production or held for resale. Generally, once the tax accounting method is selected, it can only be changed with IRS permission.

The Code contains many limitations and restrictions on available accounting methods and the manner in which deductions can be taken. Consult with your accountant and rely upon him or her in making these decisions.

## Inventory Method

Each corporation with inventory must select an approved inventory method. Usually, these methods are elected on the corporation's first income tax return. These rules are quite complex and some corporations are required to use certain types of inventory methods. Again, you should rely upon your accountant to make these decisions.

## The "S" Election

By the fifteenth day of the third month of a corporation's tax year, a corporation must choose whether it wants to be treated as an S corporation. The requirements of an S corporation and its disadvantages are discussed in greater detail below.

If you decide to operate as an S corporation, you will need to (1) file the election; (2) choose the appropriate date; and (3) make the election promptly.

The Code requires that the election be filed by the fifteenth day of the third month after the beginning of the corporation's tax year. If the election is made, make sure that it is mailed to the correct IRS Service Center by U.S. certified mail, return receipt requested. Check on the return receipt within 15 days and check on a response to the filing within 45 days. The burden of proving the filing is on the taxpayer as is the burden for strict compliance with the filing requirements.

## **Amortizing Syndication & Startup Costs**

The Code allows a new corporation to elect to amortize certain organizational expenses over a period of not less than 60 months. If the election is not made, the corporation must capitalize the expenses and deduct them upon dissolution.

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## Federal Tax Planning

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Among the tax planning topics that you will likely encounter are: (1) C corporation marginal rates; (2) stock qualification under Code § 1244; (3) reducing payroll taxes; (4) dealing with corporate losses; (5) capital asset writeoffs; (6) avoiding excessive compensation imputation; (7) capital gains exclusions; (8) application of additional tax rates; and (9) intangible writeoffs.

A C corporation pays taxes on its own income. For a corporation facing significant capital costs, the use of the lower marginal tax rates of a C corporation may produce a total lower tax cost. For example, an individual in the highest personal tax bracket (39.6%) needs to purchase \$50,000 in new assets for his business. The amount of pretax income the business must earn to make such a purchase is \$58,824 as a C corporation; and \$72,464 as an individual.

The use of the lower marginal tax brackets of a C corporation can provide some relief to the cash flow needs of a new business. The use of the marginal tax brackets is not available to personal service corporations.

If the stock qualifies as Code § 1244 stock, a shareholder will be able to recognize a loss up to \$100,000 on a jointly filed individual return or \$50,000 on a single filed individual return on its disposition as an ordinary loss instead of a capital loss. This benefit accelerates the recognition of the loss. For example, assume a shareholder without any capital gains incurred a stock loss of \$30,000. If the stock qualified as § 1244 stock, the shareholder can deduct a current year ordinary loss of \$30,000. If the stock was not qualified, the loss would be limited to \$3,000 this year and a carry-over of a \$27,000 capital loss.

A shareholder employee can lease personal assets to the corporation. The rental payment should be at a fair rental value for the asset, and the asset must be an ordinary and necessary part of the business. The corporation will be entitled to a corporate income tax deduction, and the individual will have non-wage income not subject to FICA tax.

Fringe benefits can be used to save payroll taxes. If an employer pays an employee's business expenses as an ordinary and necessary business expense, FICA tax is generally not due. Also, parts of expenses due to meals and lodging provided to employees for the convenience of the employer may be excluded from the employee's taxable wages for both income tax and FICA tax

purposes. The Revenue Reconciliation Act of 1993 eliminated or sharply reduced many employee benefits, such as moving expenses, club dues, business meals and entertainment, and spousal travel costs.

Employer provided health and disability insurance coverage provided to a class of employees is excluded from wages for FICA tax purposes. Generally, amounts contributed on an employee's behalf to a qualified plan will not result in FICA tax to either the employee or employer, and distributions to the employee are not subject to FICA tax. Important limitations apply in this complex area. You should consult with a qualified tax specialist in your planning.

Most small businesses lose money for their first six to eighteen months. Often the shareholders invest their savings in the new venture. An S corporation causes the losses to flow through to the shareholders and reduces their personal taxes. Although items to be considered in electing S corporation status involve more than the flow through of start-up losses, use of an S corporation can improve shareholder cash flow by reducing their taxes.

The Revenue Reconciliation Act of 1993 dramatically changed planning for S corporations. With the top individual tax bracket at 39.6% and the top corporate rate at 35%, it may make sense to eliminate the S election if the corporation is expected to generate significant taxable income. Review your situation with your tax advisor.

Once the business is generating a profit, the S election can be ended either by electing termination for the end of the corporation's tax year, or by triggering an event which automatically ends the election.

Code § 179 allows a taxpayer to elect to expense up to \$25,000 of depreciable personal property each tax year. The deduction is reduced to the extent that (1) the business does not have profits; and (2) the total equipment purchased exceeds \$200,000. For S corporations, the § 179 limitation of \$25,000 in writeoffs is applied at both the corporate and the shareholder level.

The IRS has been aggressive in attacking excessive compensation as a constructive dividend, thus creating additional corporate income taxes because the dividend is not deductible. The IRS is less successful in its attack when the corporation had established a formula governing compensation. It is advisable to have the owner employee's compensation set by a formula which is built on future growth in the corporation's revenues.

Effective for stock originally issued after August 10, 1993, taxpayers who hold qualified small business stock for more than five years will face a maximum capital gains tax of only 14%. This

benefit is extremely complex and can be easily violated during the five-year holding period. The new rules place requirements on both the shareholder and the corporation.

When a shareholder intends to use the new rules and is a minority shareholder, an agreement should be made with the corporation requiring it to continue to comply with the requirements of the Code. Corporate redemptions can end the special treatment, including redemptions which occurred before the stock was issued.

Corporations with taxable income over \$15 million pay an additional 3% tax on taxable income between \$15 million and \$18,333,333. This tax eliminates the benefit of the 34% bracket and cannot exceed \$100,000. Effectively, there is a 38% corporate income tax on taxable income from \$10 million to \$18,333,333. For corporations having a fiscal year end, the tax rate is a blended rate.

The 1993 Tax Act imposes an additional 1% on corporate taxable income over \$10 million. The rates for the corporate accumulated earnings tax and the personal holding company tax increased from 28% to 39.6% effective January 1, 1993. Corporate alternative minimum taxes ("AMT") were simplified. The corporate AMT rate remains 20%.

The Taxpayer Relief Act of 1997 repealed the corporate AMT for small business corporations for tax years beginning after December 31, 1997. Generally, a corporation whose gross receipts do not exceed \$5,000,000 is a small business corporation. Other rules apply to determine if the corporation qualifies each year thereafter.

Effective August 10, 1993, most intangible assets and goodwill which are acquired can be written off over 15 years. This includes goodwill, going concern values, covenants not to compete, franchises, trademarks, and trade names. The rules are fairly complex and many exceptions apply. Taxpayers also have the option of using the 15-year amortization for goodwill and intangibles gotten after July 25, 1991. The new rules do not generally apply to off-the-shelf software or software which is gotten as part of a business asset purchase.

Beware of using covenants not to compete to provide current deductions to purchasers. Under the Act, the covenant will be required to be written off over 15 years, not the term of the covenant.

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## Post-Incorporation State Tax Issues

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The state tax issues you will encounter in the post incorporation stage include: (1) initial filings; (2) the state tax law effects of federal tax elections; and (3) apportionment of income.

A corporation must obtain tax identification numbers for the principal state of its business operations and any other state with which the corporation has a business nexus. Among the likely required filings are those for sales and use taxes and a withholding tax number. Besides these filings, if the business expects to have any employees in the state, it will often need to obtain a number from that State Department of Labor.

Business licenses may be required by both county and city authorities. Contact local authorities to find out what is required. The fees are generally due annually and may be subject to penalties if not paid within a specified time. The first year license fee may cost less than the normal fee if the corporation is created several months into the year. Some states limit the maximum business license fee which can be assessed against certain professions.

Some states impose a net worth tax on each corporation operating in the state. This tax is besides the corporate income tax.

Although states generally follow elections made by corporate taxpayers under the Internal Revenue Code, states may provide for certain exceptions. Check the rules in your state.

### **State Limitations on Federal Elections**

Most states allow all federal elections and deductions unless the taxpayer is not considered a state resident or is not subject to state tax. Exceptions to the federal rules like the following exist in some states:

- An S corporation with nonresident shareholders will not be recognized unless the nonresident shareholders pay a state income tax on their proportionate share of the S corporation income;
- Corporations which receive income from outside the state and are part of a consolidated group for federal filings, are required to file separate returns in the

state unless the Department of Revenue has approved the filing of state consolidated returns;

- If tax-free exchanges occur (e.g., a like-kind exchange), the replacement property must be located in the state to have the transfer of the original property be treated as a tax-free exchange;
- Net operating losses cannot be carried over to the corporation's current year income taxes if the corporation was not subject to the state's taxes when the losses were incurred; and
- Dividend received deductions are allowed only to the extent that the recipient corporation and the paying corporation are both subject to the state's taxes.

### **Apportionment of Income**

Some states provide a method for the apportionment of income of a corporation operating in more than one state. In addition, state law may allow a corporation to request the state Department of Revenue to use a different method for deciding the corporation's taxable income in that state.

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## Shareholders' Meetings

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In general, states require that the shareholders meet at least annually as provided for in the corporation's bylaws. Failing to hold an annual meeting can affect the validity of the corporate shield. Special meetings of the shareholders can generally be called by the board of directors; the persons authorized in the bylaws or articles; if certain designated levels of shareholders demand a meeting; and in certain situations, when ordered by an appropriate court, in which the Corporation's registered agent is. The shareholders of a corporation can generally sign a consent resolution instead of any action which could be taken in a shareholder's meeting.

Notice of a shareholders' meeting must generally be given at least 10 and no more than 60 days before the meeting. Notice can be waived unless a shareholder objects at the beginning of a meeting.

Unless otherwise provided in the articles, a quorum exists if a majority of the shares entitled to vote are present at a meeting.

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## Directors' Meetings & All Authority

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Every corporation must have a board of directors. The board is generally responsible for setting policy and procedures. It is the primary governing body in a corporation. The articles and bylaws of the corporation can restrict the authority of the board.

Unless otherwise provided for in the articles, directors are elected by a plurality of votes cast. The articles or bylaws may restrict who may serve as a director. The number of directors can consist of as few as one, or such other number as may be established by the bylaws or articles.

Board meetings may be held in person or by conference call on a telephone. Instead of a meeting and unless restricted by the corporation's bylaws or Articles, actions by the Board can be made by written consent resolutions. Unless otherwise provided by the bylaws or articles, no notice is required for regular board meetings and notice of board meetings can be waived.

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## Officers' Duties & Authority

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The authority of an officer is established by two major elements: the bylaws or as set by the board. Officers of a corporation have "apparent authority" to transact the business normally associated with their respective positions. Third parties who have no knowledge of restrictions on the authority of an officer are not bound by such restrictions in dealing with the officer.

The board of directors has the authority to remove any officer with or without cause, and a corporation may have voluntary or mandatory indemnification of its officers, employees, and agents.

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## Corporate Records & Shareholder Information

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For general records maintenance, a corporation must:

- Keep permanent records of minutes, consent resolutions, waivers of meetings, and similar organizational documents;
- Maintain corporate accounting records;
- Maintain a list of shareholders;
- Maintain its records in written form;
- Maintain copies of the articles of incorporation and bylaws;
- Maintain all written communications to shareholders generally within the last three years;
- Maintain copies of the corporation's most recent annual registrations with the Secretary of State, or similar state official; and
- Maintain the names and addresses of the corporation's current directors and officers.

The Internal Revenue Service may also require copies of these records in an audit.

### **Other Recordkeeping Duties**

Other typical recordkeeping duties in the corporation laws and bylaws include:

- **Inspection.** Generally allows a shareholder to inspect and copy corporate records. Note that the statute may restrict access to certain records;
- **Financial statement.** Prepare an annual balance sheet and income statement, and, upon written request, provide the financial statements to any shareholder;
- **Other reports.** Notify the shareholders if the corporation indemnifies or advances expenses to a director with or before the next shareholders' meeting;

- Keeping copies. One of the most frequently asked questions is the length of time corporate records must be maintained. See Appendix A for a schedule of recommended holding periods. The list is an estimate of holding periods, not a legal requirement. Sometimes materials should be held even longer (e.g., IRS approvals of elections).

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# Intellectual Property Issues

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Intellectual property concerns for the new corporation will typically fall into three categories: trademarks, trade names, and trade secrets.

## Trademarks

A trademark is a registered name giving the owner a priority in the use of the trademark in its industry. A state trademark gives some protection of the name in the state in which the registration is made. A federal trademark protects the name throughout the United States for businesses using or expanding the use of the name after the registration.

## Trade Name

A trade name is different from a trademark. If the corporation operates under a name different from its legal name, it is using a trade name and needs to register that name. Check local law for the requirements of filing for use of a trade name. In Massachusetts a filing is required with the city or town clerk where the corporation operates.

## Trade Secrets

One major issue facing a business is the protection of its confidential and proprietary trade secrets. Several tools are available under the Uniform Trade Secrets Act ("UTSA") to provide this protection.

- **UTSA restrictions.** The UTSA restricts the use of confidential information and provides remedies for the release of such information. UTSA does not require a contract to enforce its provisions and does not affect contractual remedies.
- **Employment agreements.** If the potential costs warrant the protection, an employee agreement can also be adopted. Be wary of state laws which may provide significant protection, and sometimes restrictions on, employers seeking to use non-competition provisions in employment agreements. The employment agreement should be reached before employment begins.
- **Shareholder agreements.** A shareholder agreement may also be used to provide for protection of trade secrets.

## Copyright Ownership

A key legal issue for corporations in copyrights is ownership and control.

Under the Copyright Act (the "Act"), the author or creator of a work is generally the owner of the copyright unless the work meets the definition of a "work for hire" or "work made for hire". Once it is established that a work is made for hire, the hiring party, not the creator, is presumed to be the author. That presumption can be overcome by a signed written agreement to the contrary. Without that agreement the creator will have lost two key benefits of copyright ownership; the right to share in reuse fees and be identified as the author. The work for hire rules are very technical and often confusing. It is very important for both freelancers and those who rely on freelancers to fully understand the work for hire rules before any work starts. This memorandum is written from both the freelancer's and the client's point of view.

How Is A Work For Hire Created?

Under the 1976 Copyright Act which governs works created after January 1, 1978, a work created by an independent contractor cannot be a "work for hire" unless certain conditions are met. The threshold issue is whether the creator of the artistic or literary work is an "employee" or "independent contractor." The answer to this question will often decide who owns the initial copyright.

Specially Ordered Or Commissioned Works

Generally, freelancers and independent contractors initially own their copyrights. Of course, an author can assign his or her copyright, or any of the exclusive rights comprised in copyright, to a third party. While an assignment is not unreasonable in certain situations, in situations where reuse fees arise (e.g., freelance magazine writing, book publishing), the practice is generally not used.

For a specially ordered or commissioned work to be "for hire," two specific tests in the Act must be met. First, there must be a written agreement. Second, the work must fall into one of the following specific classes of works: (1) a translation, (2) a contribution to a motion picture or other audiovisual work, (3) a contribution to a collective work (e.g., magazine or encyclopedia), (4) a supplementary work (e.g., introductions, or notes used to illustrate, explain, or revise a main work), (5) a compilation, (6) an instructional text, (7) a test, (8) answer material for a test, (9) an atlas. If the work does not fall into one of these nine categories, no work for hire exists.

The Act also requires that both parties sign a written document that expressly states the work shall be considered a work for hire. If the parties have not spelled out their work for hire arrangement in writing, no work for hire exists.

Some controversy exists over whether a work for hire agreement signed after the work is created is valid, with more recent cases tending to hold that they are **not valid**. Hiring parties should make certain that work for hire contracts are signed and countersigned before work actually begins.

#### Works Created By Employees

A work created by an "employee" within the scope of his or her employment is automatically considered a work for hire. However, since the term "employee" is a legal term of art, not defined by statute, there is often confusion over who is an "employee." This confusion will grow as more people work at home or telecommute.

Until recently, the courts defined the term "employee" very broadly. As a result, freelancers often forfeited their copyright whenever the hiring party retained the right to "control" their final product. In 1989, the Supreme Court decided that freelancers should not be considered "employees" under the Act just because their works were "actually controlled" by the hiring party. As a result of this decision, the courts now consider approximately twenty factors. Among the most important are: (1) the extent of the hiring party's control over when and how long to work, (2) the location of work, (3) the skill required, (4) the payment of employee benefits, (5) the tax treatment, (6) the hiring party's right to assign additional projects, (7) the ownership of tools, and (8) the method of payment. An important issue in the context of employer/employee relationships is whether works prepared after hours or on weekend are outside the scope of employment. The result of these new tests is that in many cases corporations who think they own a work because it was "made for hire" do not. One of the most important recent cases holding this was took ownership of the CAPTAIN AMERICA characters away from the publisher, creating millions in liability for the corporation.

#### Tips For Hiring Parties

- Get it in writing. All agreements should be clearly spelled out in writing and signed by both parties before any work is done. Without a formal agreement expressly stating the work shall be considered a work made for hire, the creator is the owner and author of the work despite any expectation or verbal agreement to the contrary. The agreement must state that this work shall be considered a work made for hire within the meaning of the Copyright Laws of the United States.

- Informal agreements or letters generally will not support a work for hire. Without a properly drafted agreement, should there be a dispute, the courts will decide the parties' respective roles and rights. For example, whenever two parties work together without an agreement, there is the possibility joint authorship will be inferred from the circumstances. Joint authorship occurs when two or more authors create a work with the intention their contributions be merged together into a single work. Under copyright law a relatively small contribution may, absent a contrary agreement, entitle a co-author to an equal share of profits.
- A work for hire agreement should always include a simultaneous assignment or transfer of copyright. This will come in handy if later the work is found not to be a work for hire.
- For hiring parties, categorizing a work as a work made for hire is better than obtaining rights under assignment. Under the Act, an author can terminate an assignment 35 years after first publication. Works for hire cannot be terminated. Understand, however, that by characterizing a work as a work for hire, an "employer" may subject themselves to state worker's compensation coverage, unemployment insurance coverage, and other similar tax ramifications.

## Conclusion

Hiring parties should consult accountants and attorneys for professional advice regarding the structure of the relationship. How the relationship is structured will ultimately determine fundamental issues like ownership and tax treatment.

Freelance artists and independent contractors should also have competent legal advice before signing a work for hire agreement. By signing such an agreement, the creator will give up many valuable rights. Unless there is a written contract signed by the independent contractor which states that the work is a work for hire, and the work falls within one of nine special categories, the creator owns the copyright.

Resolving any of these issues on a winner take all basis ignores the fact that winners and losers may have to work together again. There must be an incentive for both the creative and business communities to continue their relationship. With that in mind, and within the guidelines set forth in the Act, it is possible for both sides to negotiate in good faith and come away feeling they have won something.

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## Securities Law Issues

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A thorough discussion of federal and state securities laws is beyond the scope of this guide. Some common issues are: (1) registration, (2) notices and (3) disclosure.

### **Registration**

The sale of small amounts of stock to intrastate shareholders is usually exempt from state and federal registration requirements. Never rely on this general rule without doing specific research first!

### **Notices**

Mark the back of any stock certificates with notices which may apply to the shares.

### **Disclosure**

Even if a registration exemption applies, federal securities laws require full disclosure of any material facts in a securities transaction.

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## Qualification To Do Business

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If a corporation transacts business in another state, it may be required to register in that other state and appoint a registered agent in the state.

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# Shareholder Agreements

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Shareholder agreements are designed to deal with a multitude of issues, including:

## **Buy-Sell Agreements**

Buy-sell agreements provide for and restrict how a shareholder may sell his or her shares. These agreements may include provisions authorizing a shareholder to buy out the interest of another shareholder.

## **Voting Trusts**

Voting trust agreements allow a trustee to vote the shares of a shareholder.

## **Shareholder Agreements**

Shareholder agreements can define the rights and obligations between and among the shareholders and can restrict or impair the normal rights and obligations of the board of directors. If the rights and obligations of the board are limited, however, the shareholders take legal responsibility.

A transfer of shares subject to a shareholder agreement takes subject to the agreement if he or she has notice of the agreement. If the existence of the agreement is noted on the certificate, the transfer is assumed to have such knowledge.

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## Appendix A - Estimated Record Retention Guide

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Accident reports/claims (settled cases)	7 years
Accounts payable ledgers and schedules	7 years
Accounts receivable ledgers and schedules	7 years
Audit reports	Permanent
Bank reconciliations	2 years
Bank statements	3 years
Capital stock and bond records, ledgers, transfer registers, stubs showing issues, record of interest coupons, options, etc.	Permanent
Cash books	Permanent
Charts of accounts	Permanent
Checks, canceled (see exception below)	7 years
Checks, canceled (for important payments, i.e., taxes, purchases of property, special contracts, etc. Checks should be filed with papers pertaining to the underlying transaction)	Permanent
Contracts, mortgages, notes and leases:	
(expired)	7 years
(still in effect)	Permanent
Correspondence (general)	2 years
Correspondence (legal, important matters)	Permanent

Deeds, mortgages, and bills of sale	Permanent
Duplicate deposit slips	2 years
Employment applications	5 years
Expense analyses/expense distribution schedules	7 years
Financial statements (year-end, other optional)	Permanent
Garnishments	7 years
General/private ledgers, year-end trial balances	Permanent
Insurance policies (expired)	5 years
Insurance records, current accident reports claims, policies, etc.	Permanent
Internal audit reports (longer retention periods may be desirable)	3 years
Internal reports (miscellaneous)	3 years
Inventories of products, materials, and supplies	7 years
Invoices (to customers, from vendors)	7 years
Journals	Permanent
Magnetic tape and tab cards	1 year
Minute books of directors, stockholders, bylaws, and charter	Permanent
Notes receivable ledgers and schedules	7 years
Option records (expired)	7 years
Patents and related papers	Permanent
Payroll records and summaries	7 years
Personnel files (terminated)	7 years
Petty cash vouchers	3 years

Physical inventory tags	3 years
Plant cost ledgers	7 years
Property appraisals by outside appraisers	Permanent
Property records, including costs, depreciation reserves, year-end trial balances, depreciation schedules, blueprints, and plans	Permanent
Purchase orders (except purchasing department copy)	1 year
Purchase orders (purchasing department copy)	7 years
Receiving sheets	1 year
Retirement and pension records	Permanent
Requisitions	1 year
Sales commission reports	3 years
Sales records	7 years
Scrap and salvage records	7 years
Stenographer's notebooks	1 year
Stock or bond certificates (canceled)	7 years
Subsidiary ledgers	7 years
Tax returns and worksheets, revenue agents' reports, and other documents relating to determination of income tax liability	Permanent
Time books/ cards	7 years
Trademark registrations and copyrights	Permanent
Training manuals	Permanent

Union agreements	Permanent
Voucher register and schedules	7 years
Voucher for payments to vendors, employees, (included allowances and reimbursement of employees, officers, etc., for travel and entertainment expenses)	7 years
Withholding tax statements	7 years
Voucher register and schedules	7 years