IN BRIEF

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Pitfalls in Incorporating an Existing Business

Incorporating an existing business involves much greater risk than incorporating a completely new venture. This is true whether the new business entity is expected to be a corporation, a limited liability company, or some other form of business entity. Following are a few key issues to consider in such situations.

Existing Agreements

It is important to review all of the business's existing contracts to determine whether these contracts can and should be assigned to the new entity.

Many contracts – particularly real property leases – require the other party's consent to assign the contract. Consent-to-assignment provisions vary widely. Some require advance notice before assignment – 30, 60, and 90 days advance notice provisions are not uncommon.

Some consent-to-assignment provisions give the other party – particularly landlords – discretion to grant or withhold consent. With such power, landlords sometimes try to extract more favorable terms from the "new" tenant (such as increased rent).

Special problems may exist regarding contracts secured by the unincorporated business's assets. Often such contracts will treat the transfer of assets as an event of default. A UCC search should be undertaken with the Oregon Secretary of State and other appropriate government entities. If the old business has assets that secure a debt or contractual obligation, negotiations with the secured party may need to occur early in the process.

When feasible, the new entity should enter into new contracts, replacing the old unincorporated business with the new incorporated business as the contracting party. Absent such a new contract, or a novation agreement, the old business owner will likely remain personally liable for corporate nonperformance.

Insurance policies are another example of contracts that need to be issued in the name of the new entity. Find out whether tail coverage is available on the old policy to protect the business owner from claims arising before the transfer but asserted after the transfer.

The lawyer should make sure that all customer contracts permit the new entity to perform in place of the old business.

Licenses

The lawyer should ask about governmental licenses and permits. Generally, governmental licenses and permits are not transferable, and the new business itself will need to apply for its own licenses and permits.

Enough time should be budgeted for the licensing/permitting process. For example, if an Oregon contractor is also licensed in Washington, the state of Washington will first require the new Oregon corporation to become authorized to do business in Washington as a foreign corporation before Washington will consider the new corporation's contractor license application.

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If the ownership of vehicles will transfer to the new entity, appropriate license transfers will need to occur, and new insurance policies will need to be obtained on these vehicles.

Trademarks

If the business owns a federally registered trademark, that mark must be assigned through the U.S. Patent & Trademark Office. The USPTO advises trademark owners to record the ownership transfer (assignment) with the Assignment Services Division of the USPTO.

To record an assignment, the owner must file a Recordation Form Cover Sheet along with a copy of the actual assignment or proof of name change. Requests to record documents in the Assignment Services Division can be filed through the USPTO Web site at **http://etas.uspto.gov**.

Trade Names

Trade names, or assumed business names, are different from corporate names. It is possible to have an assumed business name registered in a single county or group of counties. There could be a "Ray's Pizza" in Portland, Salem, Eugene, and Medford – each owned by a separate owner and each with a filed assumed business name.

But corporate names (and LLC names) can only exist statewide. A business with the assumed business name, "Ray's Pizza" – filed only in Multnomah County – will not be able to incorporate as "Ray's Pizza, Inc." if there is another business with the assumed business name "Ray's Pizza" filed for a different Oregon county. However, the new entity could incorporate under some other available name and then be assigned the assumed business name filing of "Ray's Pizza" for Multnomah County.

A number of Oregon cases involve corporations that continued using the trade name of the prior unincorporated business. Unless persons who do business with both entities are given some notice of the change in entity, the former sole proprietor – now shareholder or LLC member – may be held personally liable for the acts of the new entity, since third parties may think they are continuing to do business with the old owner personally, not with a completely new entity. See *Salem Tent & Awning Co. v. Schmidt*, 79 Or App 475 (1986). However, in *Andrews v. Spencer*, 193 Or 615 (1953), the corporate officer added "Inc." after the trade name, even though "Inc." was not actually a part of that trade name. The court in that case held that this act constituted sufficient notice of a change in business entity and did not impose personal liability on the officer.

If the corporation chooses to use the same name as the old business, the lawyer should stress the importance of always including the "Inc." or "Corp." when writing the business name and, in all cases, the importance of indicating the agency capacity of the person signing the contract.

Contribute the Business

Merely forming a new entity with the name of the old business (plus "Inc.") is not enough: the "business" must actually be transferred to the new entity. Some written document should evidence this transfer. Usually, this occurs through the exchange of the old owner's assets for the new entity's stock (or LLC membership interests) through a Stock Subscription Agreement. The Subscription Agreement or other asset transfer documents should spell out precisely which assets and liabilities are being offered in exchange for the new corporation's stock. The corporation should specifically accept the Subscription Agreement's offer.

In some circumstances, the old business's owner may want to lease certain assets to the new corporation, rather than contributing these assets in exchange for stock. In such cases, title to those assets will remain with the old, unincorporated business. This may be advisable when there is substantial debt associated with such assets and when the transfer could trigger adverse tax consequences, or when the transfer of ownership of such assets may trigger an acceleration of the debt obligation. For corporations that have not elected S corporation status, the lease payments may be another way for the owner to withdraw profits without double taxation. Asset leases, coupled with a UCC filing, may also offer a means for the owner to salvage some value should the new business fail. However, when leasing assets to the new entity, it is advisable not to get too greedy, as the concept of "gross undercapitalization" poses a risk that the new corporation or LLC could be pierced and personal liability imposed on the owner if not enough value is contributed to the new entity.

Usually, the old business's cash and accounts receivable should not transfer into the new entity, as there may be tax consequences to getting these funds out again. But once again, the concept of gross undercapitalization requires that the owner contribute sufficient capital in relation to the corporation's anticipated business and liabilities. See *Klokke Corp. v. Classic Exposition, Inc.*, 139 Or App 399, 405-6, 912 P2d 929, 929, *rev den*, 323 Or 690, 920 P2d 549 (1996). The contribution of some cash and/or accounts receivable may be required if the net worth of the other assets and li-

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abilities being contributed is inadequate.

Since the old owner will likely remain personally liable on the old business's debts, consider whether these debts should be assumed by the new entity or simply paid off by the old owner. Particularly if the new entity will have additional owners, the old owner may want to keep control over payment of these old liabilities. There can also be negative tax consequences to the old owner if the debt assumed by the new entity exceeds the tax basis of the assets contributed.

On the whole, tax considerations are usually the most important factor in deciding which assets and liabilities to contribute to the new entity, and which assets and liabilities should stay with the old owner.

Tax Issues

Tax issues are particularly important when an existing business is incorporated. Most owners will want to avoid realizing gain or other immediate tax consequences when the ownership of assets is transferred to, or when liabilities are assumed by, the newly incorporated entity.

Before the business is contributed to the new entity, the lawyer should consult with the owner's accountant to analyze the nature and value of the assets and liabilities proposed to be transferred and to discuss the tax implications associated with the transfer of these assets and liabilities.

Section 351 of the Internal Revenue Code (IRC) provides that certain transfers of assets by the old business owner (i.e., the unincorporated business) to the new corporation are not deemed a "sale" of these assets, thus not constituting a taxable event. Lawyers should review IRC § 351.

But not all contributions of assets and liabilities will avoid tax consequences to the old business owner. For example, under IRC § 351, taxable gain may occur if the owner receives back from the corporation anything other than stock (i.e., "boot") in exchange for the assets contributed. If the new corporation assumes a liability of the old business (i.e., the owner of the new business), the general rule is that the transferor's resulting relief from liability is not treated as boot under IRC § 357(a), but there can be exceptions.

Other provisions of the Code can also trigger negative tax consequences. For example, a taxable event may occur under IRC § 357(c) when the liabilities assumed by the new entity exceed the owner's basis (not the fair market value) of the assets contributed. Another negative tax consequence could sometimes occur if the business owner transfers depreciable property to the new entity, in which case the owner may incur taxable gain under IRC §1239. Investment credits previously taken could also be subject to recapture under IRC §§ 38 – 50.

Other tax issues can arise if the new entity will have owners other than the person transferring the business. IRC § 351 applies only if the person contributing property controls at least 80% of the combined voting power of all classes of stock immediately after the transfer. In addition, employees of the old business who receive stock in the new entity risk having the stock deemed income received in exchange for services.

Once again, it is important to involve the business owner's accountant early in the planning process to avoid the unpleasant surprise of unanticipated tax consequences.

S Corporation Election

For a new corporation choosing to be taxed as an S corporation (generally, taxed like a partnership), the S corporation election form, Form 2553, must be filed with the IRS within the appropriate time frame (generally, on or before the 15th day of the third month following the first day that the corporation first has shareholders, acquires assets, or begins doing business, whichever occurs first). If the business's accountant agrees to file this form, be sure to send a confirming letter to the accountant. Otherwise, the lawyer should consider filing Form 2553 by certified mail, return receipt requested, and asking the IRS to stamp and return an extra enclosed copy.

All shareholders must sign Form 2553 before filing. If one of the new corporation's shareholders is married and lives in a community property state (e.g., Washington or California), both spouses must sign Form 2553, even though only one of the spouses is a shareholder.

S corporations are often problematic when additional owners are contemplated, or when a complicated ownership or profits structure is anticipated due to the "one class of stock" requirement for S corporations. Since this term is interpreted broadly, take care when structuring the ownership of the corporation or any distribution of profits or revenue.

Ethical Considerations

The lawyer should consider whether it is ethical to simultaneously represent both the old business owner and

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the new entity. If both old and new businesses have but a single human owner, an ethical conflict is unlikely to be present. See *In re Banks*, 283 Or 459, 584 P2d 284 (1978) (an attorney for a corporation with only one shareholder or unified family is deemed to represent both). But ethical considerations may make joint representation impossible when there are multiple owners, particularly when the new entity will have owners in addition to the owner of the contributed business.

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