Piercing the Corporate Veil

To be honest, a good deal of our clientele comes to our firm because of a problem with taxing entities. One of the most common reasons that we see is a business owner that has "pierced" his or her "corporate veil". What does that term mean exactly? While there are legal issues related to this that an attorney can address for you, for the purposes of our paper we are going to discuss this issue from an accounting/tax perspective.

Using Wikipedia, "Corporations exist in part to shield the personal assets of shareholders from personal liability for the debts of the Corporation." Corporations are usually held by shareholders, Limited Liability Corporations held by members and a sole proprietorship is held by an individual. Further, it can be simply explained as a legal concept that separates the personality of corporation from the personality of its shareholders and protects them from being personally liable for the company's debts and obligations.

In the United States, piercing of the corporate veil is one of the most litigated issues in corporate law. Courts are often reluctant to hold a shareholder liable for actions that are the responsibility of the corporation. However, courts will often do so if the corporation is non-compliant with corporate formalities, to prevent fraud or to achieve equity in certain cases of undercapitalization. The Plaintiff must prove the corporation was negligent in its formalities and protocols and operated in a haphazard manner.

What we most often see is a business owner that uses the corporate bank account as his or her own. This blending of finances or comingling of assets "pierces the corporate veil" and allows for a taxing entity or a creditor to walk right into the business owner's personal finances and hold them liable for debts of the company. To avoid this, it is always recommended that the business have and maintain its own separate bank account and financial records, separate from the owner(s).

However, there are multiple other ways to pierce the corporate veil. Corporations may fail to follow appropriate corporate formalities such as observing bylaws or not having corporate records. Shareholders may be siphoning money from the corporation to pay for personal expenses such as a Mortgage. There may be officers or directors of the corporation that were put in place by the majority shareholder, but yet hold no purpose or function within the company. Funds and assets may be comingled between shareholders and the corporation. The company may have inadequate capitalization, and it may not have assets. The corporation may have entered into contracts with no intention of fulfilling their obligations.

So how does a business avoid having the IRS or other entity "piercing the corporate veil"? Usually, it is required that a business hold an annual meeting where minutes are taken and kept on record. If you are a single member LLC, we call this "having a meeting with yourself". Minutes can be written or recorded. Keeping minutes may prevent the IRS from claiming unreasonable compensation for members or shareholders, protect against an excess of accumulated earnings, establishes and protects personal liability of directors or officers, protects against frivolous lawsuits from minority shareholders and establishes corporate authority. The Secretary is responsible for recording the minutes, which are approved by the Shareholders or Board of Directors.

A creditor may also attempt to pierce the veil of a business they are attempting to collect a debt on. In this case the creditor will be looking to go past the business and target the owner(s) personal finances and assets to collect the debt. Larger entities may setup “dummy companies” that almost act as a money laundering scheme in an attempt to protect the larger entity and avoid collections activities. In this instance a court may pierce the veil of the larger corporation in order to pay the debts owed by the dummy companies.

If you think your business may be susceptible to the piercing of the corporate veil by members of the executive team, ownership or shareholders there are things you can do to help right the ship. You may need to bring in a forensic accountant to examine the financial records of the organization and recommend internal controls. You may also need to bring in a restructuring expert to help avoid or navigate the waters related to bankruptcy, which may become an option.

Piercing the Corporate Veil opens up Shareholders, Members or Directors to liability. It is a huge responsibility for someone to serve in this capacity of a business. All it takes is for one person to either get greedy or make a costly mistake that could open up the doors to problems for everyone that is serving the organization at a higher/executive level. Remember, not only will the executive team be affected, but everyone from management down to customers may feel the impact of these actions.