Structuring a business entity in Iowa

*By Michael J. Dayton**

My article in the February issue of the Iowa Lawyer started with a discussion of Groundhog Day. I considered doing something similar with Saint Patrick's Day for this article, another fantastic holiday that revolves around drinking.

But the way the Fightin' Irish played in the FBS championship game and with the aftermath of the Te'o girlfriend hoax, I just didn't feel lucky enough to do it. That meant I had two options: 1) choose another holiday for this article; or 2) scrap the whole theme. Even though Dr. Seuss's birthday (Read across America Day) is recognized on March 2, I've decided just to give you the straight-up law this time.

My February article also described some preliminary legal issues to consider when a potential client comes to your office to form an entity. This article discusses the most obvious of those matters: which entity to use. Though there are many types of entities recognized under Iowa law — sole proprietorships, all variations of partnerships (general, limited, LLPs, LLLPs), corporations (S and C), and limited liability companies (LLCs) — this article will focus on the S-corporation and the LLC. In Iowa, the S-corp and LLC are most commonly used.

Before I begin comparing S-corps and LLCs, there are a couple of points to keep in mind. First, remember that you are not making this decision in a vacuum. Gather information from all the resources around you — organizers and/or key business personnel, accountants, bankers, risk management (insurance agents) and specialists (IP counsel, regulatory counsel) — to ensure that you are creating what your client needs.

Second, whatever entity type you ultimately choose, don't lazily rely on your forms. Begin with the form, but don't let the form do the thinking for you. Read through the document carefully to determine what changes should be made given the business plan for the entity, and brainstorm what provisions are omitted but should be included.

Limited Liability Companies

Limited liability companies in Iowa are governed by the Revised Uniform Limited Liability Company Act (RULLCA), codified at Chapter 489 of the Iowa Code. An LLC is formed under RULLCA by filing a Certificate of Organization with the Iowa Secretary of State. The certificate is a thin document only requiring the name and registered agent and office of the LLC.

The primary governing document for the LLC is the Operating Agreement, though a buy-sell agreement should be incorporated into the Operating Agreement or drafted separately from the operating agreement for any entity with two or more owners. RULLCA is a set of default rules that, subject to a few limitations, may be freely modified in an LLC's Operating Agreement.

An LLC may be owned by one or more members. There is no limit on the number or type of members. Absent an election to treat an LLC as a corporation for tax purposes, a single-member LLC is a disregarded entity for tax purposes so all income is reported directly on the member's income tax return. A multi-member LLC is a partnership for tax purposes so that income flows through to the members' income tax returns and is taxed at the members' respective income tax rates. An LLC can be managed by its members or its managers, depending on the designation in the Operating Agreement, and in either case officers may, but are not required to, be appointed.

In an LLC, each member has a membership interest, which is the bundle of rights the member has in the specific LLC as set forth in the Operating Agreement. The membership interest

includes the "transferable interest," a RULLCA-defined term that equates to the economic rights of a member in the LLC.

An LLC is very flexible for distributions and allocations. LLCs can use special allocations as long as the allocations have a "substantial economic effect," which is a fun tax issue. A proper discussion of "substantial economic effect" is beyond the scope of this article, but it generally involves the application of complicated rules that require allocations to be consistent with the underlying economic agreement of the members and be substantial, i.e., affect substantially the amounts received by members independent of tax consequences.

S-corporations

Corporations in Iowa are governed by the Iowa Business Corporation Act (IBCA), codified in Chapter 490 of the Code of Iowa. A corporation is formed under the IBCA by filing Articles of Incorporation with the Iowa Secretary of State. The articles are more robust than an LLC's Certificate of Organization, containing, among other things, information on initial directors, authorized shares, limitations on liability for directors and indemnification provisions.

The primary governing document for a corporation is its bylaws. The bylaws are less flexible than the Operating Agreement for an LLC because the IBCA contains many required provisions, as opposed to the default rules found in RULLCA. As with an LLC, a buy-sell or shareholders' agreement is highly recommended for any entity with two or more owners.

In a corporation, the shareholders' ownership interest is represented by shares (which are a more defined bundle of rights than the membership interest in an LLC). The governance structure of a corporation is less flexible than that of an LLC: a board of directors must be appointed and at least a president, secretary and treasurer must be elected as officers.

Corporations are either C-corporations or S-corporations, with the names referring to the subchapter of the Internal Revenue Code under which the entity and/or its shareholders are taxed. A C-corporation is the classic corporate entity, generally used for public companies (though publicly traded LLCs are becoming quite common). A C-corporation usually is disfavored for tax purposes, however, because it is subject to double taxation, first at the corporate level, and then on the dividends paid to its shareholders (at the shareholders' respective income tax rates). That being said, with the new top individual tax rate being increased to 39.6 percent, theoretically it may make sense for a business that isn't issuing dividends to be a C-corp.

In an S-corporation, on the other hand, the corporate income flows through to the shareholders and is taxed only at the shareholders' respective tax rates. In return for flow-through tax treatment, the Internal Revenue Code places limits on the number and type of owners and the classes of stock and distribution rights for owners of an S-corp. An S-corporation may not have more than 100 shareholders, and only individuals, estates, certain trusts and certain tax exempt organizations may be shareholders. Further, there can only be one class of stock, though an S-corp may have voting and nonvoting shares. Because there is only one class of stock, income to the shareholders must be distributed pro rata based on the number of shares owned.

Unlike an LLC which requires no filing to be taxed as a partnership, the corporation's shareholders must all join in an election to be subject to be taxed as an S-corp, and the S-election generally must be filed within 75 days of incorporation (or the first day of the tax year in which the S-election is to be effective).

Comparing S-Corps and LLCs.

In most cases, because of the flexibility of the LLC versus the S-corp, the LLC will be preferable over the S-corp. In the cases where an S-corp is preferable, it will generally be for tax reasons, and usually self-employment tax reasons.

The following differences between an S-corp and an LLC, as previously discussed, generally favor the use of an LLC: 1) there must be 100 or fewer S-corp shareholders, and only certain entities may be S-corp shareholders, while there are no such limitations for an LLC; 2) S-corp profit and loss allocations and distributions must be pro rata based on ownership percentage, while LLCs can use special allocations and distributions (subject to substantial economic effect); 3) S-corp governance is regimented among shareholders, a board of directors and officers as prescribed by the IBCA, while LLCs may be manager- or member-managed (with many shades of gray in between); 4) rights and obligations among shareholders, directors, officers and the corporation are established by statute and generally may not be modified, while rights and obligations among members, managers, officers and the LLC are, by default, established by RULLCA but generally may be modified in the Operating Agreement; and 5) an S-election must be made to obtain favored tax treatment for an S-corp, while no such filing is required for an LLC.

With respect to self-employment (SE) tax, the salary of an employee-shareholder in an S-corp is subject to SE tax, while the employee-shareholder's distributions are not. Distributions are also generally taxed for income purposes at a lower rate than ordinary income (at least that used to be the case). That doesn't mean the employee can set his salary as low as possible and take mountains of distributions – that's how you end up in the newspaper or the back of this periodical – but a reasonable bifurcation between salary and distributions is permitted.

In an LLC, which is taxed as a partnership, all monies distributed to a "general partner" are subject to SE tax, while no monies distributed to a "limited partner" are. A person is generally classified as a limited partner unless the person has i) personal liability for the LLC, ii) authority to contract on behalf of the LLC, or iii) participated in the LLC's business for more than 500 hours per year.

Although subsection (i) of the definition of a limited partner is rare in a closely held LLC, subsections (ii) and (iii) are very common in a closely held LLC that operates a business. As such, in certain circumstances, an S-corporation may be preferable for a client that is performing services out of or for her S-corporation because of the favorable tax treatment that can be obtained by splitting the S-corp's income between salary and distributions.

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