

# 2015 Nuts & Bolts Seminar Coralville (Eastern Iowa)



## TRANSACTIONAL TRACK Business Formation

**12:30 p.m.- 1:30 p.m.**

**Presented by**

Cynthia Lande

Brown Winick PLC

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Materials provided by Michael Dayton.



**FRIDAY, OCTOBER 2, 2015**

# BUSINESS ENTITY BASICS

## MICHAEL DAYTON

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**MICHAEL DAYTON** is a shareholder in Nyemaster's Business, Finance, and Real Estate Department. Michael assists entrepreneurs from the start up to the eventual sale or other wind up of their businesses and with everything in between. At start up, his practice includes: organization of entities and joint ventures; buy-sell and shareholder agreements; venture capital; private equity; and securities law. At sale or wind-up, his practice includes: mergers and acquisitions (asset purchases and stock purchases); share exchanges and spinoffs; leveraged buy-outs; transition planning; shareholder disputes; and dissolution of entities. The in-between includes: general contracting (including contract management processes); distribution agreements; employment and consulting arrangements; corporate governance; website and e-commerce development agreements; lending and secured transactions; corporate finance; regulatory matters; local counsel opinions; and commercial transactions. Michael has assisted professionals and companies in a variety of industries, including: health care (hospitals, clinics, physicians, insurance companies); agribusiness; family farms; construction, supply, distribution and advanced manufacturing; creative services, branding, printing and merchandising; wind energy, biodiesel and other renewable energy; trucking, warehousing and logistics; chemical manufacturing and distribution; animal and human health ingredient production; vegetation management; swine genetics; agricultural equipment finance; software development; casino and gaming; and banking.

## Disclaimer

**The following presentation does not represent legal advice. If you have specific questions concerning specific circumstances, please consult your attorney.**

## General Advice

➤ **Build a team (not working in a vacuum):**

- Organizers/key business personnel
- Accounting
- Financial/Banking
- Risk Management/Insurance
- Legal (other lawyers in your firm)
- Special technical expertise (e.g., regulatory, IP counsel)

➤ **Remember the “counseling” part of your profession**

## Principal Selection Considerations

- Liability protection
- Ownership structure
- Governance/management structure
- Capital structure (including P&L allocations, distributions)
- Income and other tax considerations
- Future transfers of the business or attracting investors

## Business Structures

- Sole Proprietorship
- Limited Liability Company
  - ✓ Single member
  - ✓ Multi-member
- Corporations
  - ✓ C Corp
  - ✓ S Corp
- Partnerships
  - ✓ General (including LLP)
  - ✓ Limited Partnership (including LLLP)

## Sole Proprietorship

- No filing required – single person carrying on business for profit
  - If using trade name, county filing required (I.C.A. Ch. 547)
- No entity-specific limited liability (insurance)
- One owner; one decision-maker; one person for allocations/distributions
- Own all business assets in personal name
- Owe all business liabilities personally
- All income is taxed to owner individually and reported on Schedule C of owner's personal income tax return
- To transfer the business, each individual asset must be transferred and each separate liability assumed
- Consider single member LLC as alternative (not helpful for torts)

## Limited Liability Companies

- Governing Documents
  - ✓ Certificate of Organization
  - ✓ Operating Agreement
  - ✓ Buy-Sell Agreement
- Liabilities owed solely by LLC (absent piercing or personal guaranties)
- Ownership
  - ✓ Single Member LLC (one member, individual or entity)
  - ✓ Multi-Member LLC (as many as wanted, individuals or entities)
  - ✓ Assets owned by LLC
- Governance
  - ✓ Member or manager managed
  - ✓ Officers may be named



## LLCs (cont'd)

- Each member has membership interest (including transferable interest)
- Consider representing interest by “Units”
- Membership interest = all rights as member in Company
- Transferable Interest = economic rights
  - ✓ Can be subjected to a Charging Order by a judgment creditor.
  - ✓ Charging Order creates “lien” on Transferable Interest then can be foreclosed.

## LLCs (cont'd)

- For income tax purposes, single-member LLC is a “disregarded entity.” As a result, all income is taxed to the member and reported on the member’s income tax return
- Multi-member LLC is usually taxed as a partnership so that income flows through to the members’ income tax return and taxed at the members’ income tax rate
- Multi-member LLC – flexible for distributions and allocations
- Multi-member LLC needs EIN. Single-member LLC must have EIN if it has employees and pays wages
- LLC (including single-member) also generally recognized for other taxes (e.g., state sales and use taxes).

## LLCs (cont'd)

- To transfer the business, can transfer assets or interests (Units)
- Buy-sell:
  - Restricted Transfers
  - Permitted Transfers
  - Voluntary Transfers
  - Involuntary Transfer Events
  - Purchase Price and Payment
  - Consider Mandatory Buy-Sell/Deadlock
  - Drag/Tag/Put/Call
  - Boilerplate

## Corporations

- Governing Documents
  - ✓ IBCA (less flexibility than RULLCA)
  - ✓ Articles of Incorporation
  - ✓ Bylaws
  - ✓ Shareholders' Agreement
- Limited Liability
- Owners are shareholders – ownership interest represented by shares
- Governance: Board, Officers, Shareholder Voting, Dissenter's Rights

## C Corporations

- Name refers to election to be taxed at corporate level under Internal Revenue Code subchapter C
- Classic corporate entity. Common example is a publicly traded company
- Many shareholders
- Double taxation creates tax inefficiency
  - ✓ Income is taxed first at the corporate level (1<sup>st</sup> level tax)
  - ✓ Dividends paid to shareholders from corporate income are taxed at the shareholders' tax rates (2<sup>nd</sup> level tax)

## S Corporations

- Limitations on shareholders
  - ✓ Cannot have more than 100 shareholders
  - ✓ Only individuals, estates, certain trusts and certain tax-exempt organizations can be shareholders. No “nonresident alien” shareholders
- Limitations on stock
  - ✓ Only one class of stock, but can have voting and nonvoting shares
- File election to be subject to Subchapter S of Internal Revenue Code
- All shareholders must join in election
- Income must be distributed on a pro-rata basis based on ownership.
- Income flows through to the shareholders and is taxed at the shareholders’ tax rates

## Shareholder Agreement

### ➤ Shareholder Agreement

- Buy-Sell Provisions
- Voting Agreements
- Matters Requiring Stockholder Approval/Supermajority
- Confidentiality
- Non-Compete
- Guaranties/Contribution
- Preemptive Rights
- Registration Rights

## Partnerships

- Generally similar to LLC, except...
- No required filing (or intent) – occurs by 2 or more persons associating to carry on a business for profit; For LLP – file statement of qualification
- Liabilities are owed by the partnership and general partners jointly and severally (but no liability for LLP)
- Partnership Agreement – similar to Operating Agreement, can modify many statutory defaults, except ability to dissociate
- By default, all partners have authority to bind partnership
- Partnership automatically dissolves upon certain events



# Limited Partnerships

- Generally similar to LLC, except...
- Certificate of Limited Partnership (or LLLP) required
- At least one general partner – sole governance control, only authority to bind
- General partners have joint and several liability with LP (unless LLLP)
- In Iowa, limited partners can participate in management of the LP to certain extent and retain liability protection

## S Corp v. LLC

- Eligible Owners
  - ✓ S Corp owners must be “eligible shareholders”
  - ✓ No restriction on entity types that can be LLC members
- Income/Loss/Distribution Allocations
  - ✓ S Corp pro rata based on ownership percentage
  - ✓ LLCs can use special allocations as long as allocation has substantial economic effect. “Substantial economic effect”:  
Application of complicated rules that require, generally, allocations to be consistent with underlying economic agreement of members and be substantial, i.e., affect substantially amounts received by members independent of tax consequences.

## S Corp v. LLC (cont'd)

- Cash Distributions
  - ✓ Not taxable to extent of basis for both S Corp and LLC
- Property
  - ✓ S Corp: Gain recognized by S Corp on distribution of appreciated property; gain passed through to shareholders for basis adjustment
  - ✓ LLC: No gain or loss recognized by partnership on distribution of property and so none passed through to members. Property has carryover basis in hands of members
- Self Employment Tax
  - ✓ S Corp: Salary of employee shareholder subject to SE tax. Distributions on stock are not subject to SE tax.

## S Corp v. LLC (cont'd)

- Self Employment Tax (cont'd)
  - ✓ LLC:
    - General partner subject to self-employment tax
    - Limited partner is not. Generally classified as a limited partner unless:
      - Personal liability for the partnership
      - Authority to contract on behalf of the partnership
      - Participate in the partnership trade or business for more than 500 hours per year


# Questions?

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## Shareholder Agreement

➤ Shareholder Agreement

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### Questions?

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