

The National Agricultural  
Law Center



*A research project from The National Center for Agricultural Law Research and Information of the University of Arkansas School of Law • NatAgLaw@uark.edu • (479) 575-7646 • www.NationalAgLawCenter.org*

---

## **An Agricultural Law Research Article**

# **PART I: AN OVERVIEW OF ORGANIZATIONAL AND OWNERSHIP OPTIONS AVAILABLE TO AGRICULTURAL ENTERPRISES**

by

Carol R. Goforth

**The National Agricultural Law Center**

University of Arkansas School of Law

1 University of Arkansas

Fayetteville, AR 72701

July 2002

**Part I: An Overview of Organizational and Ownership  
Options Available to Agricultural Enterprises**

**Table of Contents**

A.	Introduction . . . . .	3
1.	Scope of Article . . . . .	3
2.	Business and Tax Considerations . . . . .	4
3.	Special Rules Applicable to Agricultural Operations . . . . .	5
B.	Sole Proprietorship . . . . .	6
1.	Business Law Status . . . . .	6
2.	Tax Status . . . . .	7
C.	General Partnerships . . . . .	7
1.	Business Law Status . . . . .	7
a.	The Different Uniform Partnership Acts . . . . .	7
b.	General Principles of Partnership Law . . . . .	9
i.	Formation and Nature of Business . . . . .	9
ii.	Liability of Owners . . . . .	10
iii.	Management and Authority . . . . .	11
iv.	Fiduciary Obligations . . . . .	12
v.	Sharing of Profits and Losses . . . . .	14
vi.	Transfer of Ownership in the Partnership . . . . .	15
vii.	Dissolution and Termination . . . . .	17
2.	Tax Status . . . . .	19
a.	Introduction to Partnership Income Taxation . . . . .	19
b.	Allocations of Income and Loss to the Partners . . . . .	21
c.	Special Allocations and Substantial Economic Effect Rules . . . . .	23
3.	Review of Important Drafting Considerations . . . . .	28
D.	Limited Partnership . . . . .	31
1.	Business Law Status . . . . .	32
a.	Formation . . . . .	32
b.	Management of a Limited Partnership . . . . .	32
d.	Contrasting a Limited Partnership with a General Partnership . . . . .	34
e.	Dissolution and Termination . . . . .	35
2.	Tax Status . . . . .	36
3.	Continued Viability of the Limited Partnership . . . . .	38
E.	Limited Liability Partnerships . . . . .	38
1.	Business Law Status . . . . .	38
a.	Formation . . . . .	39
b.	Limitation on Liability of General Partners . . . . .	39
c.	Comparing an LLP to a General Partnership . . . . .	42
d.	Choice of Law Problems . . . . .	43
2.	Tax Status . . . . .	44

F.	Limited Liability Limited Partnerships .....	44
1.	Business Law Status .....	44
a.	Statutory Authorization for LLLPs .....	44
b.	Characteristics of the LLLP .....	45
2.	Tax Status .....	46
3.	Is the LLLP a Viable Alternative? .....	46
G.	Conclusion To Part I .....	47

## A National AgLaw Center Research Article

# PART I: AN OVERVIEW OF ORGANIZATIONAL AND OWNERSHIP OPTIONS AVAILABLE TO AGRICULTURAL ENTERPRISES

Carol R. Goforth\*

### A. Introduction to Part I

#### 1. Scope of This Article

This article is the first of two articles that together will provide an overview of most of the available organizational choices for persons interested in owning and operating an agricultural enterprise. Part I will address sole proprietorships, general partnerships, limited liability partnerships, limited partnerships, and limited liability partnerships. Part II will address the rules applicable to limited liability companies, corporations, and cooperatives.

The information provided in this article is general in nature does not purport to address the specific rules which apply to each of the options in each of the 50 states. For example, all 50 states have statutes governing the formation and operation of limited partnerships. Most of those statutes are based on a model act but have been modified in various ways so that the law of each state is at least slightly different from that of every other state. Notwithstanding the variation in laws from state to state, there are many attributes of limited partnerships that are generally true no matter which state law would apply. This article focuses primarily on these general rules, although it also includes references to most of the major variations on the important rules applicable to each of the entities or options discussed here.

A generic article of this kind may do more harm than good if the reader fails to understand that this is only an introduction to the topic of organizational options and not a text geared towards the specific rules that will apply in any given jurisdiction. The general information contained in this article is not intended as a substitute for the individualized advice available from experienced counsel. Rather, it is designed to help the reader learn about and compare the various options for ownership and operation of an agricultural operation.

Because this article may be consulted by attorneys as well as those who do not have a legal background, the text is written to be understandable by anyone. Footnotes contain more detailed information and citations that are likely to be of interest primarily to persons who already have a legal background, even if their normal areas of expertise do not include the law applicable to business enterprises.

---

\*Clayton N. Little Professor of Law, University of Arkansas School of Law.

This article does not address non-profit organizations or trusts, even though both of these may be employed in connection with certain agricultural operations. Rather, the focus of these materials is on the business forms listed above.

## **2. Business and Tax Considerations**

Although the emphasis in this article will be placed on the business attributes of each of the available options, it is practically impossible to separate business and tax considerations when it comes to choice of entity determinations. This article, therefore, includes both business law and most of the major tax considerations relating to each of the various forms of business enterprise that are discussed.

This article is organized by considering each of the different organizational options in turn, and each option is further divided into a consideration of business characteristics and tax status. For some of the options, additional information will be provided in a third subsection.

With regard to the business characteristics for each of the alternatives discussed, there is a brief overview of the form of business under state law, including an overview of how the organizational choice is selected, how it is owned, and default rules concerning such things as management rights, allocation of profits and losses, distributions, and transferability of ownership interests. This overview does not seek to take into account every similarity or difference between entity forms, but rather focuses on what will probably be the most significant factors when comparing one entity against another.

Certain potentially significant issues, such as the way in which federal and state securities laws may apply to different organizational choices, are also beyond the scope of this article. As mentioned earlier, the emphasis is on the attributes of each of the various organizational options under state law with regard to how the particular enterprise would be created and operated.

Also as mentioned earlier, this article addresses the basic tax considerations simply because these are often critical in making a decision of which form of ownership makes the most sense from an economic perspective. The tax considerations are made somewhat more complex by three facts: (1) the label applied to the entity or form of organization in question under state law will not control the label utilized for federal or state tax purposes; (2) many of the new forms of business enterprise do not fit easily into the rules that were drafted before state law of business organizations developed to the point where it is today; and (3) federal and state tax laws are not always in complete agreement. This article generally looks only at federal tax law.

Speaking very generally, there are only three different models of taxation employed in connection with for-profit business enterprises. With some of the options, the organization is ignored for tax purposes (for example, the sole proprietorship, joint ownership, and the single-member LLC are generally disregarded for federal income tax purposes, with any income or loss being reported directly by the owner). With most of the organizations discussed in this article, the prevailing model will be partnership taxation, and special care will be taken in this article to refer to "tax partnerships" and "tax partners" when the label is intended to refer to tax considerations rather than organizational status under state law. Thus a limited liability company (LLC) may be referred to as a "tax partnership," and its members as "tax partners" because the federal income tax code does not recognize the LLC as a separate taxable entity. (LLCs will actually be addressed in part II of this series, but this same analysis will apply to organizations set up as general partnerships, limited partnerships, limited liability

partnerships (LLPs), and limited liability limited partnerships (LLLLPs).) Finally, the tax code recognizes corporations, although there are two options for the taxation of a tax corporation (subchapter C and subchapter S). Both of these options will be discussed, at least in general terms, in the second article in this series.

Again, the purpose of including a discussion of tax considerations in this article is not to replace the particularized advice of a tax specialist. These materials are intended only as an overview to the tax issues, and the advice of a tax specialist such as a certified public accountant will generally be essential to assure the proper operation of any business organization, assuming that the goal of the entity is to pay required taxes but no more than necessary.

### **3. Special Rules Applicable to Agricultural Operations**

Several states impose limitations on the ownership and operation of specified types of agricultural operations. These “anti-corporate” farming statutes vary widely from state to state, although they typically focus on such issues as the number of shareholders, the relationship among the shareholders, whether a family member “actually” conducts farming operations, and notification requirements. Colorado, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Carolina, South Dakota, Texas, West Virginia and Wisconsin all have such statutes.

The specific limitations on what can and cannot be done vary tremendously from state to state, and most jurisdictions do not have any such statutory restrictions on the ownership or operation of farms. However, in states that do have such provisions, they must be complied with. Challenges to the statutes have generally not been successful. For example, the Nebraska statute has been upheld against a void-for-vagueness challenge.<sup>1</sup>

It is also worth emphasizing that although these limitations and restrictions are often referred to as “anti-corporate” statutes, this label is not entirely accurate. Many of the restrictions may be applied to non-corporate enterprises. For example, the Nebraska statute has been applied by the Nebraska Supreme Court to a cooperative,<sup>2</sup> and limited liability companies have been statutorily declared to be syndicates and, as such, subject to the Nebraska constitutional restrictions on farm ownership.<sup>3</sup> More recently, South Dakota adopted a state constitutional provision which prohibits most corporations and “syndicates” from acquiring an interest in “real estate used for farming.”<sup>4</sup> The South Dakota prohibition applies to any “limited partnership, limited liability partnership, business trust, or limited liability company,” but does not include general partnerships unless nonfamily farm syndicates or

- 
1. Hall v. Progress Pig, 610 N.W.2d 420 (Neb. 2000).
  2. Pig Pro Nonstock Cooperative v. Moore, 568 N.W.2d 217 (Neb. 1997).
  3. Neb. Rev. Stat. § 21-2602(2) (1997).
  4. S.D. Const. Art. XVII, § 21.

nonfamily farm corporations are partners.<sup>5</sup> Family farm corporations and syndicates are exempt from the provision.<sup>6</sup>

The purpose of this discussion is not to outline all of the potential rules affecting corporations or other businesses that seek to conduct agricultural operations in any of the 50 states. Rather, it is to alert the reader that many states do have special limitations and reporting obligations which should be researched on a case-by-case basis.

Some of the forms of business organization discussed in these two articles will be subject to varying requirements in one or more states; others (such as the sole proprietorship) should not be affected by these so-called “anti-corporate” farming statutes. However, although the popular literature tends to refer to these requirements and restrictions as being “anti-corporate,” it would be a mistake to believe that only corporations are affected by such provisions. Moreover, familiarity with the requirements in one jurisdiction does not assure familiarity with the requirements in other states.

In general, any time a business organization seeks to undertake agricultural operations in any state, the state statutes should be examined to determine if there are applicable reporting requirements or other limitations. Failure to abide by such restrictions may prove to be an expensive proposition.<sup>7</sup> It is therefore advisable to consult with experienced counsel before undertaking farming operations utilizing any of the business forms discussed here, with the exception of the sole proprietorship, which does not appear to be affected by such statutes in any state. The following materials do not emphasize any of these requirements, and instead focus on the general attributes of each of the forms of business under consideration.

## **B. Sole Proprietorship**

### **1. Business Law Status**

A sole proprietorship is a business owned and operated by a single individual. While that individual may hire employees or other agents to assist him or her in conducting business operations, the proprietor is the sole owner of the business. Moreover, the business has no legal existence independent of the proprietor. There is no entity that can sue or be sued or that can shield the proprietor from personal liability for debts arising out of the business.

Because there is no separate legal entity, in most states there is no statute that governs the formation and operation of a sole proprietorship. The business will be subject to state laws and

---

5. *Id.*

6. S.D. Const. Art. XVII, § 22(1). There are other exemptions as well, including exemptions for certain cooperatives, nonprofit corporations, per-existing ownership arrangements, research and experimental operations and certain other arrangements. S.D. Const. Art. XVII, § 22.

7. For example, the South Dakota provisions permit the state Attorney General to commence an action to enjoin illegal purchase or to force divestiture of land or livestock. S.D. Const. Art. XVII, § 24. The Nebraska Attorney General has also successfully sought divestiture, obtaining a settlement in May of 2001 against Christensen Farms, pursuant to which Christensen Family Farms was required to divest itself of all agricultural property.

regulations governing the operation of a business under a fictitious name, rules requiring licenses and permits for certain types of agricultural operations, and to general principles of agency and employment law if and when the sole proprietor hires agents or employees to assist with business operations.

In general, the proprietor has sole control over the business and all decisions relating to its operation. All debts of the business are also debts of the proprietor, and business assets can be seized to pay for personal debts of the proprietor.

Because the business has no legal existence apart from the proprietor, the proprietor will be able to use business assets for personal purposes and personal assets to meet business obligations. There need be no segregation of assets or income. All earnings or losses are attributed and taxed directly to the proprietor. There is no need for formal distributions from the business. There is also no specific procedure necessary to sell all or part of the business or to terminate operations. All assets are treated as being owned directly by the proprietor and can be sold by him or her at will. If the proprietor sells a partial interest in the business, there is at least the risk that this will convert the operation into a general partnership. This possibility will be discussed in more detail in part D.1. of this article.

## **2. Tax Status**

A sole proprietorship has no separate tax status. It is not an entity recognized under the Internal Revenue Code but is treated as an extension of the owner (proprietor). This means that the proprietor is required to report all items of income and expense on his or her personal tax return. There is a separate schedule on which to calculate profit and loss from a business, but there is no separate tax on income earned from such an enterprise (other than self-employment income, which is no more than the taxpayer's share of social security and medicaid taxes as both employee and employer). Rather, the income is added to any other taxable income attributable to the proprietor. Similarly, if there is a loss from the business, such loss can generally be deducted from other taxable income earned by the proprietor.

## **C. General Partnerships**

### **1. Business Law Status**

The general partnership is a very flexible form of enterprise. State partnership statutes provide default rules (i.e., rules which will govern the relationship of the parties absent specific agreement to the contrary). These default rules cover issues such as management rights and the way to calculate each partner's share of profits and losses. However, the partners in a partnership agreement are generally free to change these default provisions by agreement. For example, absent agreement to the contrary, all partners have equal management authority and are entitled to share equally in the profits and losses of the enterprise (after a return of each partner's initial contribution). However, these provisions can be changed by agreement, and it is not at all unusual to see a general partnership with a managing partner or executive committee with full management powers and with allocations of profit and loss among the partners that are not equal.

The partnership form of enterprise has been around for many years and is familiar to most legal and accounting professionals who have a business practice. As such, there is a high familiarity factor and there are a number of resources which can be relied upon for forms and research.



However, there have been some very significant developments in the recent past, and with the spread of more modern partnership statutes, some of the tried and true ways of doing things may no longer be the best.

a. The Different Uniform Partnership Acts

If this article had been written a few years earlier, the discussion of partnership law would have been considerably simpler. At that point in time, every state, except Louisiana, had adopted a version of the Uniform Partnership Act, a piece of model legislation originally promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1914. This model act, known as the UPA, resulted in a great deal of consistency in the way in which partnerships operated, even though most states had incorporated at least minor revisions to the statute as adopted in each jurisdiction.<sup>8</sup>

However, even though the UPA provided for a great deal of consistency and relative certainty, there were certain issues that led to a number of problems. Over the years, an increasing number of commentators suggested that it was time to revisit the question of what the ideal state partnership statute should look like. The NCCUSL undertook the reform project, and eventually promulgated a Revised Uniform Partnership Act (which was typically referred to as RUPA) in 1992.<sup>9</sup> The timing was, in some respects, unfortunate. Limited liability partnership (LLP)<sup>10</sup> legislation was sweeping the nation after having been “invented” by Texas in 1991. The original RUPA, however, did not incorporate language authorizing or otherwise dealing with LLPs, and thus in some sense the model legislation was outdated from the moment it was promulgated. Moreover, there were other criticisms of the act which prompted the NCCUSL to consider a number of amendments to the RUPA.

The first set of amendments to the RUPA were approved by NCCUSL in 1993. The changes basically responded to a number of comments and suggestions, and at the same time the official name of the act was changed to the Uniform Partnership Act (1993). Additional amendments were adopted in 1994, at which time the act was renamed the Uniform Partnership Act (1994). In 1996, further changes were made to add provisions dealing with LLPs, and the name of the statute was changed to Uniform Partnership Act (1996). Additional changes have been made in subsequent years, and it appears that more may be adopted in the future.<sup>11</sup>

Given the speed and frequency with which the uniform act has been amended, the choice to change the nomenclature of the uniform act is quite understandable. "RUPA" may have been a convenient acronym for the Revised Uniform Partnership Act. Re-RUPA (for Revised, Revised Uniform Partnership Act) or Re-Re-RUPA (for three sets of revisions) certainly would not be. On the

---

8. The UPA, or Uniform Partnership Act (1914) may be found in volume 6 of the Uniform Laws Annotated. References in this article to the UPA are to sections of the uniform act only, rather than to the page numbers in these volumes.

9. RUPA, or the Uniform Partnership Act (1997), may be found in volume 6 of the Uniform Laws Annotated. References in this article to RUPA are to sections of the uniform act only, rather than to the page numbers in these volumes

10. LLPs will be considered in more detail in part F.1. of this article..

11. See official commentary to RUPA.

other hand, there is plenty of room for confusion when a state adopts the Uniform Partnership Act (1996) in a year other than 1996 and uses the official name of the act in the state statute.

Because a growing number of American jurisdictions have adopted the newer versions of the Uniform Partnership Act, and because the newer statute does make some potentially significant changes in the law applicable to partnerships, both statutes will be discussed here. Notwithstanding the official name of the newer uniform act, it often becomes difficult to keep references straight when a single document speaks about both the original UPA and the new UPA. Therefore, this article will refer to the UPA and the RUPA to explain general rules applicable to partnerships. The general rules may have been changed in any given state, and it is the applicable state statute which will control, rather than the terms of the uniform acts themselves or the general principles enunciated here.

b. General Principles of Partnership Law

i. Formation and Nature of Business

Regardless of whether the UPA or the RUPA controls in a given situation, a general partnership is an association of two or more persons who have agreed to carry on a business as co-owners for a profit.<sup>12</sup> No particular formalities are required to form a general partnership: there is no filing requirement and the "agreement" to form a partnership need not be in writing and need not contain any particular language.<sup>13</sup> In fact, it is possible to form a "partnership" without ever using the words "partner" or "partnership," and RUPA expressly states that intent to form a "partnership" as such is not required.<sup>14</sup> (This is not a change from earlier law, because case law had generally interpreted the UPA to operate in this manner, as well.)

How then is a partnership created? Both the UPA and the RUPA provide that joint ownership of property, whether as a joint tenancy, tenancy in common, tenancy by the entirety, joint property, common property, or part ownership does not of itself establish a partnership.<sup>15</sup> In addition, both uniform acts specify that the sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.<sup>16</sup> On the other hand, both statutes also state that an agreement to share profits creates a presumption (or prima facie case) that a general partnership exists.<sup>17</sup> The presumption can be rebutted if it is proven that the profits were paid as interest on a debt, as compensation to an employee, or in other enumerated situations.<sup>18</sup> However, even though the presumption can be rebutted, sharing of profits is a risky proposition unless a partnership relationship

---

12. UPA § 6(1); RUPA §§ 101(a) & 202(a).

13. UPA § 6; RUPA § 202.

14. RUPA § 202(a).

15. UPA § 7(2); RUPA § 202(c)(1).

16. UPA § 7(3); RUPA § 202(c)(2).

17. UPA § 7(4); RUPA § 202(c)(3).

18. UPA § 7(4)(a) - (e); RUPA § 202(c)(3)(i) - (iv).

is intended. The statutory rules create a very fine line, and the case law interpreting these rules is neither completely consistent nor predictable.

Ideally, a partnership will be documented by a written agreement, preferably drafted by experienced counsel. This serves several important functions: (1) it serves as a written record of the parties' actual agreement in case of future disputes, death of a partner, or imperfect memories; (2) it is more likely to cause parties to reflect on the more significant aspects of the partnership relationship and agree in advance as to how to deal with certain contingencies; and (3) it minimizes the risk that the parties will be surprised by the default rules contained in the partnership statute, which will apply unless the parties have agreed otherwise. (Some of the default rules may not be what people would expect or want in their business relationships.)

The foregoing discussion applies equally to the UPA and the RUPA. There is, however, one significant difference between partnerships formed under the two statutes: under the RUPA, the general partnership is explicitly recognized as an entity distinct from the partners.<sup>19</sup> This matters primarily in the event of litigation. Under the RUPA, where the partnership is an entity distinct from the partners, it can sue and be sued in its own name. Under the UPA, the individual partners must bring any action, or be sued in their own names. This rule may, however, have been changed in any given state.

#### ii. Liability of Owners

One of the biggest drawbacks to the general partnership form of enterprise is that all partners have unlimited personal liability for all debts of the partnership.<sup>20</sup> This means that if one partner in a farming partnership defrauds creditors of the partnership or steals money from them, all partners of the firm are personally liable for the full amount of any judgement entered because of the first partner's misconduct. Personal liability for entity debts covers contractual obligations of the business as well as tort liability. Here there is another potentially significant difference between the rules adopted by the UPA and the RUPA: the two statutes have different rules concerning the nature of each partner's individual liability for partnership debts.

The UPA was somewhat convoluted in its language and provided for joint and several liability in some instances and joint liability in others.<sup>21</sup> At the risk of oversimplifying, all liability under the UPA was joint, unless the partnership obligation arose out of the wrongful acts of another partner or out of another partner's breach of trust.<sup>22</sup> In these cases, the partners' liability became joint and several.

The distinction is important because of the nature of joint and several versus joint liability. Joint liability means that each partner is liable only for his, her or its pro-rata share of the obligation, and every partner is an indispensable party to a legal action to enforce a partnership obligation. Joint and several liability means that any partner can be held liable for the full amount, even if other partners

---

19. RUPA § 201(a).

20. UPA § 15; RUPA § 306(a).

21. UPA § 15(a) & (b).

22. UPA §§ 13, 14 & 15 .

cannot be found or joined in the litigation. A partner paying more than his, her or its pro rata share would then have the burden of pursuing the other partners for contribution.

The UPA rule placed a very high burden on many partnership creditors. Consequently, several states modified these rules by amending their versions of the UPA, so that there was far less than uniformity on the question of what type of liability was imposed on general partners. According to the commentary to the official version of the UPA, as of 1996, some 18 states had adopted statutory language which essentially imposed joint and several liability on all partners for all partnership obligations.<sup>23</sup> Some others had changed this rule by case law or statutes outside of the partnership act itself.

In contrast to the complicated rules of the UPA, the RUPA simply provides for joint and several liability for all partnership debts.<sup>24</sup>

### iii. Management and Authority

The starting point for considering the management rights of partners in a general partnership is the applicable statute. Both the UPA and the RUPA provide that, absent agreement to the contrary, partners in a general partnership are presumed to have equal rights to manage the partnership.<sup>25</sup> In addition, all partners are agents of the partnership, with at least apparent authority to bind the partnership to acts within the usual course of the partnership's business.<sup>26</sup> This apparent authority ceases only if the person with whom the partner is dealing knows of a restriction on that partner's actual authority. Otherwise, even if the partners have agreed to the contrary, any partner can bind the partnership so long as the act appears to be in the partnership's ordinary course of business.

Although the RUPA retains the same substantive default rules concerning management and apparent authority as appeared in the UPA, the newer statute does add some new provisions relative to the way in which a partnership might choose to operate. In particular, the RUPA provides for both a statement of partnership authority and a statement of denial.<sup>27</sup> Neither of these documents have any corollary under the UPA. Under the newer statute, these documents can affect a partner's authority in various ways.

---

23. See commentary to UPA § 15.

24. RUPA § 306(a).

25. The UPA simply says that this default rule is subject to the contrary agreement of the parties. UPA § 18. At first glance, it may be hard to figure out what RUPA provides with regard to management rights, because the statutory provision dealing with management appears to be mandatory, indicating without qualification that each member has equal rights. RUPA § 401(f). However, an earlier provision in RUPA makes virtually all of the statute subject to the contrary agreement of the parties, including these management rights. RUPA § 103.

26. UPA § 9; RUPA § 301(1).

27. RUPA §§ 303, 304.

First, however, the documents must be appropriately completed and filed. The RUPA requires any statement of partnership authority to identify the partnership's "chief executive office."<sup>28</sup> According to the comments to section 106 of the RUPA as promulgated by the National Commissioners, this language was taken from the UCC<sup>29</sup> and is apparently intended to refer to:

the place from which in fact the debtor manages the main part of his business operations.... Doubt may arise as to which is the "chief executive office" of a multi-state enterprise, but it would be rare that there could be more than two possibilities.... [The rule] will be simple to apply in most cases....<sup>30</sup>

Since there is no case law under the RUPA helping to define the term, this projection of simplicity may be overly optimistic.

In addition, there is some question about the effect of a statement of authority. What good does it do? The RUPA suggests that such a statement "may state the authority, or limitations on the authority, of some or all of the partners to enter into other transactions on behalf of the partnership and any other matter."<sup>31</sup> However, as against persons who are not partners, only grants of additional authority appear to be binding, except that properly filed denials or revocations of authority can effectively limit prior grants of additional authority.<sup>32</sup> Thus, the primary benefit of these statements is likely to be to provide affirmative proof of expanded authority, rather than to protect a partnership by limiting one or more partners' authority. In any event, because these provisions are so new, they are certainly worthy of some consideration before they are relied upon to change the normal rules of partnership authority.

#### iv. Fiduciary Obligations

A topic closely related to management power and authority is the nature of a partner's fiduciary relationship to the partnership and to the other partners. The UPA did not expressly define the extent of a partner's fiduciary obligations, although case law generally imposed very broad, fiduciary obligations on all partners. The nature of this duty may be best exemplified by the following quotation from Benjamin Cardozo, then chief judge of the New York Court of Appeals and a jurist of considerable renown: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of

---

28. This term was not used in the UPA, and is not defined in RUPA, but must be included in the statement. The concept of the chief executive office is also very important throughout RUPA. It affects the law which governs the partnership, the place where records are to be kept and many other issues, as well as being required to be identified in most of the filings permitted or required under RUPA. See RUPA §§ 106(a), 303(a)(1)(i), 403(a), 905(b)(6), 906(b), 907(b)(3), 1001(c)(2), 1003(a)(2) & (c), and 1102(a)(2) .

29. See comment to RUPA § 106: "The concept of the partnership's "chief executive office" is drawn from UCC Section 9-103(3)(d)."

30. Paragraph 5 of the Official Comment to UCC Section 9-103(3)(d), quoted in the comment to RUPA § 106.

31. RUPA § 303(a)(2).

32. RUPA § 303.

the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”<sup>33</sup>

One of the problems with this standard is that, since it did not appear in the UPA, it was not expressly made subject to the partner’s rights to contract around the default rules. Thus, the extent to which fiduciary duties needed to be addressed in partnership agreements was the subject of some debate. In addition, the absence of a statutory formulation meant that the boundaries of the fiduciary duties were uncertain and subject to change as creative lawyers came up with convincing arguments as to why the times or standards of acceptable conduct had changed.

The NCCUSL, after a great deal of debate, elected not to impose such sweeping obligations upon partners, at least not as a matter of statutory default rules.<sup>34</sup> On the other hand, the commissioners also decided that it was not appropriate to allow partners to completely undermine all fiduciary or fiduciary-type obligations simply by contracting around them.<sup>35</sup> Thus, there are significant limitations on the right of partners to agree to change the fiduciary duty rules under the RUPA. Possibly because of the attempt to resolve the dispute between those who favored very strong fiduciary rules and those who favored complete freedom to contract around any statutory obligations, the RUPA’s fiduciary duty provisions were among the most controversial of all of the RUPA’s provisions.

In essence, although the RUPA expressly incorporates principles of law and equity to the extent they are not displaced by particular provisions of the Act,<sup>36</sup> under this new statute partners are presumed to owe one another only two fiduciary duties: the duty of loyalty and the duty of care.<sup>37</sup> The duty of loyalty is limited to an obligation to account for property or anything of value derived by the partner from conducting partnership business or winding it up, an obligation to avoid dealing with the partnership as a adverse party, and the obligation to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.<sup>38</sup> This duty may not be eliminated, although a partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, so long as such provisions are not manifestly unreasonable.<sup>39</sup> In addition, the partnership agreement may allow a specified percentage of partners to authorize or ratify a specific act or transaction that otherwise would violate the duty of loyalty, so long as they do so after full disclosure of all material facts.<sup>40</sup>

---

33. Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (NY App. 1928).

34. RUPA § 404.

35. RUPA § 103.

36. RUPA § 104.

37. RUPA § 404(a).

38. RUPA § 404(b)(1) - (3).

39. RUPA § 103(b)(3)(i).

40. RUPA § 103(b)(3)(ii).

A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.<sup>41</sup> This duty cannot be “unreasonably” reduced.<sup>42</sup>

Finally, although it is not described as a fiduciary obligation, the RUPA does specify that a partnership shall discharge his duties “consistently with the obligation of good faith and fair dealing.”<sup>43</sup> The partners may not eliminate the obligation of good faith and fair dealing, although a partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.<sup>44</sup>

Although they are relatively new, a great deal has already been written about these provisions. Some commentators have praised the efforts of the drafters, but the RUPA approach has created considerable opposition from both ends of the spectrum. Those who favor the traditional approach are appalled that the standard of care is so low, and that the statute identifies what purports to be the “only” fiduciary duties of partners, although partners clearly could agree to accept additional obligations. On the other hand, those who favor allowing partners to set their own standards of care object to the fact that the RUPA includes mandatory minimum standards vis-a-vis the duty of care and duty of loyalty which cannot be eliminated or even “unreasonably” limited.

#### v. Sharing of Profits and Losses

One of the most important aspects of partnership law, and indeed the law applicable to almost any business association, is the way in which the law assigns participants the right to participate in profits and losses of the venture. Partnership law is particularly problematic because the default rule (i.e., the rule which will apply in the absence of any agreement by the participants to the contrary) may be counter-intuitive. Under both the UPA and the RUPA, the default rule is that all partners are to share equally in the profits and losses of the enterprise (after the return of each partner's contribution).<sup>45</sup> Moreover, partners are not entitled to any remuneration for services rendered to their partnership.<sup>46</sup> These rules may come as a surprise to the partners in a number of situations. A couple of examples may serve to illustrate some of the issues created by these default rules.

Consider the overly-simplified example of Abby, who in this hypothetical wants to form a partnership to help her with her small farming operation. She owns a small dairy farm, complete with milking equipment and a small herd of dairy cows. Now that her husband has died, she does not believe she can manage the farm operations by herself. In order to induce two individuals, Bert and Candace, to run the farm for her, she agrees to contribute the farm and its operating assets to the

---

41. RUPA § 404(c).

42. RUPA § 103(b)(4).

43. RUPA § 404(d).

44. RUPA § 103(b)(5).

45. UPA § 18(a); RUPA § 401(b).

46. UPA § 18(f); RUPA § 401(h).

partnership. These assets are valued at \$900,000. Bert and Candace, in turn, agree to front operating expenses for the year in the amount of \$50,000 each (including necessary upkeep and repairs). At the end of the year, if the partnership has made \$100,000 in profits, how is that amount to be shared? The answer is that, absent agreement to the contrary, each partner would share equally, despite the wildly unequal contributions. Abby may be very surprised by this result.

Sometimes it is not the “wealthy” investor who is unpleasantly surprised by the default rules. Supposed Donald is an experienced farmer but lost his farm to bankruptcy. His friend, Francesca, is willing to fund a new farming operation, specializing in organic produce for local sale, provided that Donald agrees to provide services for the operation. They form a partnership in which Francesca agrees to contribute \$250,000 in cash up front, and Donald agrees to contribute his services. They do not have any agreement about his salary or what happens if there are losses. Suppose after twelve months of operations, the business is broke. They rented the land, so they do not have it to sell. After selling all of the partnership assets, there are no outside creditors left, but no money either. Imagine Donald’s surprise if Francesca comes to him and says that he owes her \$50,000 for his share of the losses! In some jurisdictions, Francesca would have such a claim. There is a contrary view on this problem, which suggests that Donald has indeed shared in the losses because he lost the value of his services which we presume to be equal to Francesca’s contributions.<sup>47</sup> Under this view, however, if there is \$100,000 left at the end of the year, should Donald be paid half of it to equalize the return of his “contribution”? This result appears unlikely.

There are also a variety of tax and other issues that arise in the context of services-only partners, which further supports the conclusion that this is a topic which should be carefully considered by persons considering the partnership form of business. Ideally, legal and tax advisors should be consulted to minimize the risk of unpleasant surprises.

One other point should be made. The RUPA provides (at least in the absence of an agreement to the contrary) that the partners in a general partnership are deemed to have an account which is to be “credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner’s share of the partnership profits” and “charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner’s share of the partnership losses.”<sup>48</sup> These rules basically describe a “capital account,” which would be the typical way in which a partner’s right to share in profits and losses is accounted for over time. In fact, the Internal Revenue Code sometimes requires that such an account be maintained if the partnership has made certain allocations of losses that it wants to have respected for federal tax purposes.<sup>49</sup> However, because these rules do not require that the value of services are presumed to be included in

---

47. For contrasting views on whether someone in Francesca’s situation might prevail, compare *Richert v. Handley*, 50 Wash.2d 356, 311 P.2d 417 (1957) and *Richert v. Handley*, 53 Wash.2d 121, 330 P.2d 1079 (1958) (services-only partner who received no other compensation should not have to contribute towards losses), with *Kovacik v. Reed*, 49 Cal.2d 166, 315 P.2d 314 (1957) (services-only partner liable for share of losses in venture).

48. RUPA § 401(a)(1) & (2).

49. For a more detailed discussion of the requirements concerning the maintenance of capital accounts in order to insure that any special allocation of income or loss have “substantial economic effect,” see *infra* part C.2. of this article..



the partner's "capital account," the RUPA is unlikely to solve the potential uncertainty that may exist if partners make contributions in different ways and fail to address how losses are to be shared.

vi. Transfer of Ownership in the Partnership

Consider now the issue of a partner's ownership interest in the partnership. What is it that the partner owns? How is that ownership conveyed? Can creditors of a partner recover against that partner's interest in a partnership, and if so, how?

There are a couple of reasons why the rules applicable to the transferability of partnership interests deserve some special consideration. First, they are very different from the rules applicable in the corporate setting, or indeed, the rules applicable to most property interests. In a corporation, a shareholder is generally entitled to sell his, her or its stock at any time to any purchaser, and the purchaser simply steps into the rights held by the selling shareholder. This is also true of most kinds of ownership interests. In the corporate setting, while this right can be modified by agreement, the default rule essentially codifies what has long been regarded as a central attribute of the corporate form: free transferability of interests. In contrast, a partner in a partnership is not generally entitled to transfer all of the attributes of ownership to any other person, absent the unanimous consent of every other partner. The default rule under both the UPA and RUPA is that a partner can transfer his or her economic right in profits and distributions but not any of the other rights traditionally vested in partners. The assignee would not become a partner, but only an assignee with very limited rights. Again, these rules are subject to contrary agreement of the parties, but absent such an agreement, a partner's right to sell are limited.

This leads to the second reason why these rules are important and another difference between owning a partnership interest and owning other types of property. Consider the case of a corporation, ownership of which is usually evidenced by shares of stock. A shareholder has very limited rights and very limited responsibilities as a result of such stock ownership. In most cases, it should not matter who else owns shares. In a partnership, however, every partner has certain agency powers to bind the partnership, and the financial worth of every partner may be important to both the ability of the partnership to borrow funds and to repay them without increasing the individual liability of other partners. Thus, who one's partners are can matter greatly.

In addition, the lack of free transferability has economic consequences that may be important in any given situation. Exit strategies are always worth considering, and the fact that it may be hard to sell partnership interests (both in terms of finding a buyer and in terms of getting the required consents) may mean that this is economically less attractive than some other forms of business enterprise. (On the other hand, if one of the intended purposes is to insulate assets of the business from claims by creditors of the individual participants, this may be an actual advantage in some situations.)

The basic rules are not hard to state. Both the UPA and the RUPA make a partner's interest in a partnership personal property.<sup>50</sup> The uniform acts also provide that a partner's interest may be assigned.<sup>51</sup> Such assignment, however, does not automatically guarantee that the assignee will become a partner. Under both the UPA and the RUPA, absent agreement of the other partners, the

---

50. UPA § 26; RUPA § 502.

51. UPA § 27; RUPA § 503.

assignment entitles the assignee to receive only the profits to which the assignor would have been entitled.<sup>52</sup> No other rights are transferred. In other words, absent the agreement of the other partners, an assignee of a partnership interest receives only the economic rights of a partner and not the management rights. The non-economic rights, including the right to manage and to vote in partnership decisions, remain with the assignor, who continues as a partner in the partnership until and unless removed as provided by law or the applicable partnership agreement.

However, partners may admit new partners by unanimous consent or, if they have provided otherwise in their agreement, under any procedures to which they have agreed.<sup>53</sup> It is relatively common to have partners pre-approve certain classes of transferees for admission to the partnership as partners, particularly family members or successor enterprises in the event that one or more of the original partners is a corporation or other business entity. It is also relatively common for partnership agreements to provide that the only approval necessary to admit new or substitute partners is from certain specified partners, or a specified percentage, less than 100 per cent, of the partners.

The UPA does not expressly provide for restrictions on the assignment of a partner's economic interest in a partnership, although these are not unheard of.<sup>54</sup> The RUPA essentially continues these rules but expressly allows restrictions on the usual principle of free assignability of economic rights.<sup>55</sup>

Because a partner's interest in the partnership is personal property, it should be possible for a partner's creditor to obtain and perfect a security interest under the Uniform Commercial Code.<sup>56</sup> The UPA and the RUPA also permit a creditor to obtain a "charging order" against a debtor partner's interest,<sup>57</sup> although the procedure is designed for collecting judgments rather than securing the debt at the outset of a transaction. In addition, the process is somewhat confusing and appears to be rarely utilized in practice.

Anyone who advances credit to an individual based on such person's ownership interest in a general partnership should be aware that, absent agreements to the contrary, foreclosure of that interest will gain the creditor only the partner's economic rights and not any management authority. Moreover, the partnership agreement may impose restrictions even on the ability of a partner to transfer the economic rights. The partner has no direct control over a proportional interest in the

---

52. UPA § 27; RUPA § 503.

53. UPA § 18(g); RUPA § 401(i).

54. Some courts have approved such restrictions under the UPA as adopted in the applicable jurisdiction. See *e.g.*, *Nicolas M. Salgo Assocs. v. Continental Ill. Properties*, 532 F. Supp. 279 (D.D.C. 1981) (applying District of Columbia law; anti-assignment provision applied to transfer, including transfer by operation of law). On the other hand, unreasonable restraints on the transfer of partnership interests have been prohibited. See *Battista v. Carlo*, 57 Misc. 2d 495, 293 N.Y.S.2d 227 (1968) (court narrowly interpreted restriction in partnership agreement so as to preclude only sales to nonpartners).

55. RUPA § 103 contains no provision limiting the ability of partners to contract around any of the default rules relating to transfer of partnership interests.

56. See, *e.g.*, *Madison Nat'l Bank v. Newrath*, 261 Md. 321, 275 A.2d 495 (1971).

57. UPA § 28; RUPA § 504.

partnership's assets, nor any right to grant a lien on any part of partnership property without consent of the other partners. Moreover, a lender to a partner who is unable to pay a debt which is secured by a partnership interest in effect ranks below creditors of the partnership if the partnership is also insolvent. Partnership creditors will generally have superior rights in regards to partnership property.

#### vii. Dissolution and Termination

Before describing the statutory rules governing the termination of general partnerships, it is important to review some of the legal terminology because some commonly used English words are given special meanings in this context. Both the UPA and the RUPA divide the demise of a partnership into three phases: dissolution, winding up, and termination.<sup>58</sup> A partnership that has “dissolved” continues its existence for the purpose of winding up its business. Termination occurs when the winding up process is complete. Regrettably, this does not accord with the every-day meaning typically associated with these terms. Further confusing matters is the fact that “termination” under federal income tax law is a concept which does not correlate with state law and may not occur even though a partnership has dissolved and terminated under state law.

The initial step in the dissolution process is the dissociation of one or more partners. Under both the UPA and the RUPA, dissociation means a partner's withdrawal from the partnership, either voluntarily (such as by retirement or simply announcing an intent to withdraw) or involuntarily (such as by death, incapacity or removal by the other partners).<sup>59</sup> Under the UPA, dissociation triggers automatic dissolution of the partnership (dissolution being defined as the change in relationship caused by any partner's ceasing to be associated with the partnership).<sup>60</sup> Under the RUPA, dissociation need not be followed by dissolution and winding up.<sup>61</sup> Rather, the RUPA provides that dissolution may be followed by winding up of the business or, in certain circumstances, the business may be continued and the dissociating partners paid off.

Actually, the business of a partnership may be continued even after a partner's withdrawal under either the UPA or the RUPA. Under the UPA, it is possible only if the partnership agreement provides for it or if the dissolution is wrongful (which means either that the partner's withdrawal is in contravention of an express provision in the partnership agreement or that it occurred before the expiration of a definite term or the completion of a particular undertaking for which the partnership was formed).<sup>62</sup> Under the RUPA, even where a partner has rightfully dissociated, the statutory default rule is that remaining partners can elect to continue the business.<sup>63</sup> Moreover, under the RUPA, a wrongful dissociation is presumed not to trigger dissolution and winding up.<sup>64</sup>

---

58. UPA §§ 29, 30 & 37; RUPA §§ 601, 802 - 807.

59. UPA § 29, 31; RUPA §§ 601 - 603.

60. UPA § 29.

61. RUPA § 603(a).

62. UPA § 38(2)(b).

63. RUPA § 802(b).

64. RUPA § 801(2)(i).

The RUPA is not entirely clear as to whether a partner's withdrawal triggers dissolution at all. It may be that a wrongful withdrawal triggers neither dissolution nor winding up, or that it triggers dissolution without the winding up (which is what the UPA would have provided). In any event, the RUPA is slightly more flexible with regard to continuation of the business after a partner's withdrawal, but the flexibility in no way diminishes the need to pay particular attention to drafting partnership agreement provisions which carefully explain the parties' rights and obligations in the event of withdrawal of one or more partners.

Under the UPA, dissolution is triggered by any of the following.<sup>65</sup>

1. Withdrawal of a partner--A partner has the legal ability to quit the partnership at any time, even if the partnership agreement purports to prohibit such withdrawal. If a partner withdraws in violation of a provision in a partnership agreement, the partnership may recover any damages caused by the wrongful withdrawal (such as the value of the lost services or the cost of finding a replacement), and the partner may lose the right to participate in winding up the partnership's business.
2. Death of a partner who is an individual.
3. Bankruptcy of any partner or the partnership itself.
4. Expulsion of a partner pursuant to a right granted in the partnership agreement--The power to expel exists only if there are bona fide reasons for the expulsion in accordance with the terms of the agreement.
5. Events specified in the partnership agreement--Many partnership agreements contain a specific undertaking or time period, which, when complete, will trigger dissolution of the partnership.
6. Agreement of all partners--This is a statutory right; the partnership agreement can also provide for dissolution upon the vote of less than all of the partners.
7. Any event making it unlawful to carry on the business of the partnership or for these partners to do so.
8. Judicial dissolution--Upon partners' petition, a court may order dissolution upon proof that a partner has repeatedly breached his or her partnership obligations, the business can be carried on only at a loss, or "circumstances render a dissolution equitable."

The UPA only permits expansions of the causes of dissolution. There is no statutory authority to reduce the list of things that will trigger dissolution.<sup>66</sup> However, the UPA does allow the partners to agree, either in advance or at the time, that upon certain events of dissolution the remaining partner or partners may or will continue the business and succeed to its assets and liabilities, cashing out the departing partner or that partner's survivor's legal representative.

---

65. All of these events are listed in UPA § 31. See also RUPA § 801.

66. A few jurisdictions by modification of the UPA or, more rarely, by case law permit the partners to vary this list by agreement.

The RUPA contains many of these rules, as well.<sup>67</sup> However, this statute does appear to make most of the list of events which would ordinarily trigger dissolution subject to contractual modification in a partnership agreement.<sup>68</sup>

## 2. Tax Status

### a. Introduction to Partnership Income Taxation

One of the primary advantages of the partnership form of business is that there is no entity-level tax imposed on partnerships. (Note that it is possible that a partnership can elect to be taxed as

a corporation if it so desired.<sup>69</sup> Under our current tax structure, however, it is quite unlikely that a partnership would elect corporate tax status.)

Assuming that a partnership (regardless of whether it is formed under a version of the UPA or the RUPA) files no special election to be taxed as a corporation, the basic framework of partnership taxation follows: Each item of income and loss is passed through to the partners in accordance with either the default rules or the partnership agreement if the parties have agreed to a different allocation. Although there are limits on the extent to which partners can utilize partnership losses to offset other income, in general, partnership taxation is likely to be more advantageous than corporate taxation, which imposes one level of tax on earnings of the entity and then another level of tax when income is distributed to the shareholders as dividends. Moreover, corporate losses can only be utilized by the corporation and may not be used by shareholders to offset other items of income at the personal level.

Partnerships and partners are taxed pursuant to rules contained in Subchapter K of the Internal Revenue Code.<sup>70</sup> While Subchapter K consistently refers to partnerships and partners, it is important to remember that, with very few exceptions, these rules will basically apply to all unincorporated businesses. Thus, references in the Internal Revenue Code to “partnerships” and “partners” should be understood as references to entities taxed as partnerships and persons taxed as partners, regardless of how they are characterized by state law. With some notable exceptions, the following discussion will also apply to other unincorporated businesses.

As with state partnership law under the UPA, Subchapter K represents a blending of the aggregate and entity concepts. If partnerships were treated as a pure aggregate (i.e., no more than an association of individuals), each partner would be treated as if he owned an undivided interest in the partnership assets and conducted a proportionate share of the partnership business. The partnership

---

67. RUPA § 701.

68. RUPA does not list most of these circumstances in the statutory section which restricts the power of partners to contract around statutory default rules. See RUPA § 103.

69. Treas. Reg. §§ 301.7701-1 through -3, 26 C.F.R. 301 (1997). These regulations are generally referred to as the “Check-the-Box” regulations, because they presume partnership taxation for unincorporated domestic businesses with 2 or more members allow any such enterprise to elect corporate tax status by “checking a box” on an election form.

70. I.R.C. §§ 701-761.

would be irrelevant. On the other hand, if a pure entity approach was adopted, the partnership would be treated as a separate entity for tax purposes, and each partner would own an interest in the partnership rather than in the underlying assets. Subchapter K adopts an aggregate approach for some purposes and an entity approach for others. For example, a partnership is treated as a conduit which passes income through to the partners to be reported on their individual returns. This is consistent with the aggregate approach. On the other hand, for purposes of determining the amount, character and timing of partnership items, an entity approach is adopted. The hybrid entity-aggregate approach to partnerships accounts for much of the complexity of Subchapter K but generally produces sensible results.

In essence, the starting point for tax purposes is the calculation of the income of the partnership.<sup>71</sup> Once these amounts are calculated, the partnership is required to file an informational federal income tax return.<sup>72</sup> (Most state statutes also require the filing of an entity return for state income tax purposes. However, state taxation is beyond the scope of this article and will not be addressed here in any detail.)

The calculation of profits and losses may be different for tax and economic purposes. For example, the proceeds received by a partnership from a life insurance policy may not be included in computing profits for income tax purposes,<sup>73</sup> although these proceeds may constitute a significant addition to the economic assets of the entity. The informational return must include each partner's allocated share in the partnership's income or losses. This is not the same as amounts that may have actually been distributed to the partners but, instead, represents the partners' proportionate interests in items of income or loss.

#### b. Allocations of Income and Loss to the Partners

The Internal Revenue Code provides partners with considerable flexibility to structure their profit- and loss-sharing arrangements for tax purposes. Thus, a partnership agreement might provide: (1) that entity tax profits and losses will be shared among the partners in the same manner; (2) that the shares of particular partners' in the tax profits of the partnership will be different from the same partners' shares of the tax losses of the partnership; and/or (3) that particular items of tax income, gain, loss, deduction or credit will be shared differently than the overall entity tax profits and losses. However, this flexibility is subject to limitations concerning the requirement that special allocations have "substantial economic effect," and by a special provision that may mandate that gain, loss, or depreciation with respect to particular contributed properties be allocated in a certain way.<sup>74</sup> These special limitations are discussed briefly below.

---

71. I.R.C. § 703.

72. I.R.C. § 6031(a).

73. I.R.C. § 101(a)(1).

74. See, e.g., I.R.C. § 704(c). This Code provision deals with the concept of built-in gain, which occurs when a partner contributes property to a partnership in which the partner's basis is different from then-current fair market value. In this instance, when that asset is later sold or transferred, 100% of the built-in gain (ie, that proportion of gain or loss attributable to the difference between basis and fair market value at the time of contribution) will be allocated to the contributing partner.

The Internal Revenue Code provides a default rule for sharing overall entity tax profits and losses in two circumstances: (1) where the partnership agreement does not address the issue; and (2) where the partnership agreement provides for an allocation for tax purposes which does not have "substantial economic effect."<sup>75</sup> In either event, the tax default rule is that the tax profits and losses will be shared in accordance with the partner's "interest in the partnership," determined by taking into account "all facts and circumstances."<sup>76</sup> The regulations provide that the interests are "presumed to be equal (determined on a per capita basis)."<sup>77</sup> Thus, the tax default rule is that profits and losses for tax purposes will generally be shared equally unless a different sharing arrangement is provided in the partnership agreement or by law (the applicable partnership act). Since the UPA and the RUPA both provide for equal allocation of profits and losses, any modification of the tax default rules will have to be in the partnership agreement.

The tax default rule also applies where the partnership agreement makes an allocation that is subject to the "substantial economic effect" test but does not satisfy it. The regulations prescribe a number of rules that must be met in order for such an allocation to satisfy the "substantial economic effect" requirement. The conceptual objective of these economic effect rules is to insure that special allocations for tax purposes will be matched by parallel allocations for economic purposes.

On the other hand, the substantial economic effect test is generally only relevant where some special allocation is made for tax purposes that is different from the general manner in which profits and losses are being shared, since an allocation in accordance with the partner's interest in the partnership is the default rule if an agreed allocation does not have substantial economic effect. Thus, if both the tax and economic profits and losses, and all items thereof, of the partnership are allocated in the same manner, either under the terms of the partnership agreement or under the default rules of the state partnership act, the allocations should generally have economic effect. This does not require that the partnership agreement allocate everything equally between the partners in order to avoid any possible problem with the substantial economic effect rules; the only requirement is that the partnership agreement avoid having an allocation of a particular item of profit or loss that is different from the way that other items of profit or loss (from both the tax and economic perspectives) are allocated to a given partner. In other words, it is perfectly acceptable to have partner A receive a 50 percent interest in every item of profit and loss (for tax and economic purposes), while partners B and C each receive only a 25 percent interest. The potential problem arises if A's usual sharing ratio is 50 percent but the partnership agreement purports to allocate a specific item of gain or loss to A in a different proportion.

If a partnership agreement does contain a special allocation, it will be respected for tax purposes only if it has substantial economic effect.<sup>78</sup> The tax regulations provide detailed guidance on this precise point, i.e., insuring that any agreed allocations will have both tax and economic effect. Before considering these regulations in more detail, it is worth noting one other important aspect of partnership taxation, it is the allocation of income or loss which is the taxable event, not the subsequent distribution of earnings.

---

75. I.R.C. § 704(b).

76. Treas. Reg. § 1.704-1(b)(3)(i).

77. *Id.*

78. I.R.C. § 704(b).

When partnership income, determined as of the end of the year, passes through for tax purposes to the partners, they must report it, regardless of whether the partnership's profits have actually been distributed to the partners.<sup>79</sup> On the other hand, actual distributions that do not exceed a partner's share of previously taxed profits should not produce additional taxable income to the partner at the time of distribution.<sup>80</sup> This single tax approach is accomplished by providing that a partner's basis in the entity is increased at the end of the entity's taxable year by the partner's share of entity income and decreased by actual distributions. On the other hand, an actual distribution to a partner does not generally result in additional gain to the partner except to the extent a cash distribution to the partner exceeds that partner's basis in the entity before the cash distribution is taken into account.

The timing and nature of distributions can cause a problem, however. Take this simple example. A/B partnership has \$100,000 in tax profits at the end of year 1. If A and B share equally in partnership income, A and B will each report \$50,000 of the entity profits and will each increase their entity basis by \$50,000. If, for example, the entity then actually distributes \$50,000 cash to each in April of Year 2, the distribution would not exceed the previously taxed share of each, as represented by the increased basis of each in their interests in the entity. No additional gain would be recognized on the distribution, and the basis of each in their respective entity interests would be reduced by \$50,000. Assume this distribution brings the basis of each back to zero. Assume further that the entity has enough available cash flow to make a further cash distribution to each on July 1, of Year 2 in the amount of \$10,000 each. If this is an unconditional distribution, each of the partners will recognize an additional gain of \$10,000, since the cash distributed will exceed the zero basis of each in the entity. On the other hand, if this July distribution is delayed until after the end of Year 2, the partners will be able to increase their bases in the entity interests for their share of the Year 2 profits before any recognition event, and assuming those shares were at least \$10,000 each, no gain will be recognized with respect to the actual distribution.

Thus, generally, if an interim distribution during the year simply represents the undistributed share of previously taxed profits, no additional gain should be recognized on the distribution.<sup>81</sup> On the other hand, if all previously taxed profits have already been distributed, and the interim distribution is from the current year's earnings, gain may be recognized if the interim distribution is unconditional. This problem is solved where the distribution against current earnings is clearly characterized as such--as an "advance," or "loan," or "draw" against those current earnings. In this event, the interim distribution is tantamount to a loan which will be paid back out of earnings determined at the end of the year and subject to repayment by the partner to the extent those earnings are not sufficient to fully offset the earlier draw. The tax regulations provide that no distribution occurs with respect to a loan, draw, or advance until the end of the partnership's taxable year, as of which date the partner's earnings for the year are determined, and the basis in their entity interests will be increased to reflect

---

79. I.R.C. § 701.

80. I.R.C. § 731.

81. *But see* I.R.C. §§ 704(c), 737 (certain distributions in connection with contributed property trigger gain); 707(a)(2)(B) (distributions that represent proceeds from "disguised sale" of contributed property trigger gain or loss); 751(b) (certain distributions trigger gain under disproportionate distribution rules).



such earnings.<sup>82</sup> If the advance to a partner does not exceed the partner's profit share for the entire year, therefore, no additional gain should occur with respect to the actual distribution.

Thus, for example, if the \$10,000 distributed to each A and B on July 1 of Year 2, is treated as an advance or draw against Year 2 profits only, A and B would not be taxed on receipt of the advance on July 1. If the entity has \$20,000 of profits for all of Year 2, A and B would report their \$10,000 share each, as determined at the end of the year. The basis of each would increase for their \$10,000 share of profits. Then, when the \$10,000 advance to each is canceled against the \$10,000 share of profits of each for all of Year 2, the cancellation will be treated as a distribution of money occurring at the time of cancellation in the amount of the cancellation. No additional gain will be recognized on the deemed distribution since each will have \$10,000 of new basis in their entity interests to offset the deemed distributions.

### c. Special Allocations and Substantial Economic Effect Rules

In general terms, a tax allocation which differs from the partner's "interest in the partnership" will not be respected for tax purposes if the allocation does not have "substantial economic effect."<sup>83</sup> Tax regulations describe each partner's "interest" in the entity as signifying "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated."<sup>84</sup> The tax regulations provide a presumption that the interests are equal but describe a number of factors which can be taken into account in determining each partner's "interest."<sup>85</sup>

Generally, if a special tax allocation of income, gain, loss, deduction or credit is made to a partner that is different from that partner's "interest" in the partnership, the item will be reallocated for tax purposes in proportion to the partners' usual interests unless the special allocation has "substantial economic effect." Since an allocation in accordance with the partners' "interests" is the default fall-back rule, allocations that are made in accordance with such "interests" will generally cause no problems. If the partners' distributions rights are uniform (that is, no special allocations are provided), whether by reason of the default sharing rules of the UPA or RUPA, or as provided in a partnership agreement, the formal requirements of the "substantial economic effect" test of the tax regulations will therefore be inapplicable.

On the other hand, if a special allocation is made of tax income, gain, loss, deduction, or credit to a partner or partners that is not in accord with that partner's or those partners' general sharing rights, the substantial economic effect test will have to be satisfied if the allocation is to be respected for tax purposes. A simple example will illustrate the issue. Assume that A and B are equal partners in AB partnership. The partnership has \$100,000 in net income for tax and economic purposes for Year 1. The normal sharing arrangement is 50/50 for both tax and economic purposes. Assume that A and B have both agreed that the entire \$100,000 net income will be allocated to A for tax purposes because A is in a lower tax bracket than B, while the \$100,000 net income for economic purposes will

---

82. Treas. Reg. § 1.704-1(a)(1)(ii).

83. I.R.C. § 704(b).

84. Treas. Reg. § 1.704-1(b)(3)(i).

85. Treas. Reg. § 1.704-1(b)(3)(i).

be split as usual between A and B. If A and B were allowed to do this, the primary impact would be to lower the amount of taxes paid. Partners would be free to allocate tax items among themselves in order to reduce tax liabilities without changing their economic claims against the entity. The "substantial economic effect" requirements are designed, in effect, to prevent tax allocations divorced from economic allocations. Oversimplifying a bit, the substantial economic effect requirements generally require a special tax allocation be accompanied by a parallel allocation for economic purposes.

The regulations provide that the "substantial economic effect" test as applied to special allocations is actually two tests: (1) the allocations must have "economic effect" as provided in the regulations,<sup>86</sup> and (2) the economic effect of the allocations must be "substantial."<sup>87</sup> Thus, even if an allocation has "economic effect," it may still be ignored for tax purposes if the economic effect is not "substantial."

The economic effect part of the test is easier to understand in conceptual terms than in the complex provisions of the tax regulations which implement it. Very generally, the point of the test is to require that an allocation of income, gain, loss, deduction, or credit to a partner for tax purposes be accompanied by a parallel allocation for economic purposes, one that will impact on the partner's economic claims against the partnership. The key mechanism for tying tax and economic allocations together is a capital account for each partner. In essence, in order for tax allocations to be considered to have "economic effect," the tax regulations require that the partnership agreement provide the following: (1) that the partnership maintain capital accounts for each partner in accordance with rules provided in the regulations; (2) that upon liquidation of the partnership, distributions to the partners be made in accordance with their remaining positive capital account balances; and (3) that any partner whose capital account shows a deficit upon liquidation be required to repay the amount of that deficit to the partnership within a specified period of time.<sup>88</sup> These requirements have obvious drafting implications, since a partnership agreement will have to provide for them, as there is no equivalent statutory default rule under either the UPA or the RUPA.<sup>89</sup>

The requirements relating to the maintenance of the capital account are generally intended to provide a running series of adjustments made on an economic basis to each partner's account that will parallel allocations for tax purposes. For example, if A contributes property worth \$100,000 to the partnership, with a tax basis of only \$50,000, and B contributes property with both a value and tax basis of \$100,000, the regulations would require that these contributions be "booked" by crediting the capital account of each with \$100,000, reflecting the equal value of the contributions, even though the partnership's tax basis in the property contributed by A would be only \$50,000. If the partnership sells the property contributed by A for \$110,000, ignoring any basis adjustments, it will have a book profit of only \$10,000 with respect to the property, although it has a tax gain of \$60,000 and, assuming equal

---

86. Treas. Reg. § 1.704-1(b)(2)(ii).

87. Treas. Reg. § 1.704-1(b)(2)(iii).

88. Treas. Reg. § 1.704-1(b)(2)(ii)(b).

89. RUPA does presume the existence of capital accounts. RUPA § 401(a). RUPA does not, however, incorporate all of the requirements embodied in these federal tax regulations.

sharing, \$5,000 of that book profit would be added to the capital accounts of each of A and B.<sup>90</sup> The capital accounts of each would not be adjusted for the \$50,000 of tax gain in addition to the \$10,000 of book gain. Similarly illustrating that the capital accounts are maintained on an economic rather than tax basis, if the partnership were to realize \$10,000 in taxable and \$10,000 in tax exempt incomes, for a total of \$20,000 in income, \$10,000 would be credited to the capital account of each of the partners. If an actual distribution is made to the partners, their capital accounts are decreased by the amount of distribution received by each.

The capital account, as maintained under the tax regulations, thus represents the running total, constantly adjusted, of the economic claims the partner has against the partnership. The interim adjustments that are made to the capital accounts have an economic impact, since the partnership agreement must generally provide that liquidating distributions to partners will be governed by their capital account balances at that time.

Under the requirements described above, a partner who has been allocated more losses than the total value of the partner's contributions will show a deficit capital account balance, which the partnership agreement must generally require be repaid.<sup>91</sup> For example, if A and B each contribute \$100,000 as their original contributions, and the partnership has losses of \$150,000 over its operating history, with all of those losses being allocated for tax purposes (and, as a corollary, for capital accounting purposes) to B, the capital account balances of each would look like this (taking only these facts into account):

	A	B
Opening Balance	\$100,000	\$100,000
Losses	( 0 )	(150,000)
Balance	\$100,000	(\$50,000)

Under the third economic effect test requirement, the partnership agreement would have to provide that B must repay \$50,000 to the partnership, which would use it to pay creditors or to distribute to other partners. Here, B would repay \$50,000, which, added to the \$50,000 the partnership otherwise has remaining (\$200,000 original contributions less \$150,000 losses), would be distributed to A as a return of A's \$100,000 capital account balance.

On the other hand, B may be reluctant to have to pay not only creditors but also partners for amounts that were always intended to be at risk in the venture. On the facts of the example, however, if B is required to repay the \$50,000 capital account deficit, B's liability has not been limited only to the original \$100,000 contributed by B, and A will have lost nothing at all out of A's original contribution.

Because this result may be unpalatable, the tax regulations provide alternative ways in which the third part of the economic effect test can be satisfied. One alternative is to eliminate the third

---

90. The required tax treatment of the built-in gain that is caused by the fact that the contributing partner had a basis in the property that was less than its fair market value at the time of contribution is the primary instance where the Code would in effect mandate a special allocation. I.R.C. § 704(c). All of such built-in gain (\$50,000 in the textual example) must be allocated to the partner who contributed the property. The additional \$10,000 in gain (which is attributable to post-contribution appreciation) would be allocated to the partners in accordance with their interests in the partnership or as provided in the agreement if the agreement complies with the rules concerning special allocations.

91. *Id.*

requirement (the deficit account repayment obligation) but provide in the partnership agreement that no allocation will be made to a partner that will cause or increase a deficit in that partner's account after taking any anticipated distributions to that partner into account.<sup>92</sup> Thus, for example, a partnership agreement provision of this sort would have allowed B in the example above to be allocated no more than \$100,000 of the \$150,000 stipulated losses. Under this approach the partnership agreement must also provide for a "qualified income offset."<sup>93</sup> Under such a provision, a partner who receives an unexpected allocation or distribution that causes or increases a deficit account balance must then be specially allocated items of income or gain "in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."<sup>94</sup>

There is also a purely practical alternative to the requirement that any capital account deficit be repaid. Even if the partnership agreement does not contain the third requirement, allocations that would otherwise be respected (because the first two economic effect tests are satisfied) will be respected as long as they, in fact, do not create any capital account deficits, because to that point the allocations do have economic effect. Thus, for example, the allocation of the first \$100,000 in losses to B would have economic effect as to B because there was that much value to start with in B's capital account. It would only be the remaining \$50,000 allocation, after B has nothing more to lose in an economic sense, that would not be respected if B had no repayment obligation and the "qualified income offset" alternative is not provided.

The tax regulations also require that the economic effect be "substantial," which essentially means that the economic and tax effect of any allocation must be matched on a dollar for dollar basis. At this point, it is probably worth re-emphasizing that the point of this extended discussion of tax regulations is not to create a do-it-yourself guide for persons considering the possibility of establishing a partnership out of which to run their agricultural operation. Rather, this article is intended to provide the kind of background information that should make it easier to consult with a tax advisor and to effectively communicate concerns and preferences. In addition, this information may make the ultimate advice provided by such an expert easier to understand. This article should not be read as an alternative to consulting with a tax advisor but in connection with such consultation.

Turning now from the issue of whether a special allocation has "substantial economic effect," there are other important limitations on the partners' ability to utilize losses that are allocated to them. Ideally (at least from the partners' perspective), when a partnership allocates losses to the partners, those partners would be able to use such losses to offset other income, thereby reducing overall tax liability.

One of the most important of the limitations on this ability is the rule that a partner's deduction for his or her distributive share of partnership loss is limited to his or her basis at the end of the partnership tax year in which the loss occurred.<sup>95</sup> A partner's initial basis depends on how that

---

92. Treas. Reg. § 1.704-1(b)(2)(ii)(d)(1), (2), (3).

93. *Id.*

94. *Id.*

95. I.R.C § 704(d); Treas. Reg. § 1.704-1(d)(1).

partnership interest was acquired,<sup>96</sup> and this basis is continually adjusted to reflect the partner's share of partnership income, expenses, and distributions. Basis is increased primarily by additional contributions or deemed contributions and the partner's distributive share of partnership income.<sup>97</sup> It is decreased primarily by distributions or deemed distributions, and the partner's share of distributive losses.<sup>98</sup> One benefit of being a general partnership is that a partner is deemed to contribute an amount of cash equal to that partner's share of partnership debts,<sup>99</sup> although this also means that a taxpayer recognizes income when his or her share of such debts are discharged without payment.<sup>100</sup> For any given partner, these rules may or may not present limitations on the availability of losses to offset other income. Additional tax rules exist which may further restrict a partner's ability to utilize losses that are attributable to nonrecourse debts.<sup>101</sup>

Another limitation on the usefulness of losses arises when those losses are allocated to partners who are not actively engaged in the business of the partnership. The Internal Revenue Code imposes significant limitation on the right of such partners to utilize such "passive losses." Speaking very generally, losses from a passive trade or business activity may be taken only against gains from passive activities; they may not be used to offset other income (nonpassive activity gains).<sup>102</sup> An activity is considered to be "passive" if the taxpayer in question (the partner) does not "materially participate" in the activity or rental activity. A partner will be recognized as "materially participating" in the trade or activity only if he or she "is involved in the operations of the activity on a basis which is regular, continuous and substantial."<sup>103</sup>

The point of this discussion is to provide the type of background information that should make it possible to understand and respond to recommendations from a tax adviser about these types of issues. In very broad terms, a partnership does not itself pay taxes. Taxes are paid on the income by each partner, in proportion to his or her distributive share, regardless of how much is actually paid out by the partnership each year. Subject to numerous rules, some of which have been briefly described here, losses are also passed through to the partners. Partnership income taxation and accounting are, however, sufficiently complex that it is generally advisable for each partnership to consult with an

---

96. The basis rules are complicated, and will not be reviewed in detail here. For a relatively simple explanation of these rules, see Jerold A. Friedland, *Understanding Partnership and LLC Taxation* 129-79, LEXIS PUBLISHING (2000).

97. See generally I.R.C. §§ 705(a)(1)(A), 722, 752(a).

98. See generally I.R.C. §§ 7705(a)(2), 733, 752(b).

99. I.R.C. § 752(a), 722.

100. I.R.C. § 702.

101. I.R.C. § 465. This provision limits a taxpayer's deduction for losses from an activity to the amount at risk in such activity (i.e., his capital contributions, plus liabilities for which he or she bears personal liability).

102. I.R.C. § 469.

103. I.R.C. § 469(h)(1).

experienced tax advisor about the specifics of how these rules will apply to any given situation. Individual partners may also need individualized tax advice.

### 3. Review of Important Drafting Considerations

A partnership agreement may be as long or short as the partners need. To the extent that the partnership statute includes default rules that coincide with the partners' preferences, it is not even essential that a partnership agreement address all of the important issues that are likely to arise during the course of business operations. However, there are some advantages to having a written agreement incorporate rules that would apply even in the absence of the agreement: (1) it prevents or at least reduces the chances of future arguments about the actual terms of the agreement; (2) if the partners forget the default rules, it is easier to check the agreement than to call the attorney or look things up in the statutes; and (3) it reduces the chances that the partnership will inadvertently incorporate default rules which are different from what the partners had expected.

The following is a list of substantive provisions which might be included in a formal partnership agreement. Even if no written document is prepared, these are certainly the kinds of issues that partners should agree upon in advance:

#### PROVISIONS FOR FORMAL PARTNERSHIP AGREEMENTS

1. **Names and Addresses of Partners** - This may also include the status and state of organization for non-individuals.
2. **Name of Partnership** - Any conflict with the trade name of another or similar business name should be resolved; the agreement might need to recite any relevant permissions and who granted those permissions. If the partnership wishes to register its name, this may also be included in the agreement, along with authorization to pay any required fees or renewals. These provisions may address what happens to the name of the partnership upon reorganization, any provision for the continued use of a decedent partner's name, and any restrictions on using the partnership name in other activities.
3. **Purpose of Partnership** - A partnership agreement might specify the authorized business activities in order to limit the scope of usual partnership activities. If this is done, the agreement may also recognize the possibility that these purposes may change. Any limitations on business activities should be expressed rather than implied, and it should be understood that any limitation on the authority of any partner to conduct operations within the usual scope of the partnership's activities is not likely to be effective as against those who do not know of such restrictions. This may also be the place where any limitations on the rights of partners to engage in competitive business activities may be expressed.
4. **Term of Partnership** - The partnership agreement may have a particular term, set forth in terms of a particular date or the requirement of termination upon the completion of specific activities.
5. **Initial Contribution of Partners** - This is one of the most critical parts of a partnership agreement, particularly where contributions are not all in the form of cash, paid in advance. The agreement should probably state the amount of the contribution to be made; the date the

contribution(s) are to be made to the partnership; the form of contribution(s); the agreed-upon valuation of contributions other than cash (which is especially important for a variety of tax purposes, and probably should be discussed with the partners' tax advisors); any interest to be paid on contributions prior to formation of the partnership if contributions are made in advance; any adjustments that may be made in contributions required from each partner; any provision for loans to the partnership; the effect of failure to contribute; and in the event that one or more partners are to contribute services, the value of such services, the value of any capital interest being acquired, and the consequences of failure of performance. (There are very intricate tax consequences associated with contribution of services to partnerships in exchange for capital interests, and these issues should be discussed in advance with the partners' tax advisors).

6. **Additional Contribution Requirements** - If additional contributions may be required, the agreement should address the procedure for establishing the necessity and amount of any such required amounts, as well as the timing and form of any such additional contributions. The agreement should also cover the notification procedures associated with any requirement for additional contribution; the apportionment of any additional contribution among partners; a provision for redistribution of partnership interests for non-proportional contributions, and procedures if a partner fails to make required contributions.
7. **Assets of Partnership** - A partnership agreement may seek to identify assets, to set forth rules governing how title to assets is to be held, provide an agreed-upon valuation of or method for valuation of assets, establish control over assets and accountability for partnership assets, and list any rules about the distribution of assets.
8. **Liability** - A partnership agreement may cover the topic of the partners' liability to one another or even the partners' liability to third parties, although these provisions will not be able to adversely affect the rights of third parties.
9. **Allocation of Profits and Losses** - Every partnership should agree upon how profits and losses are to be divided among the partners. If any partner is guaranteed a share of profits, this should be specified. If salaries are to be paid, this should be addressed, particularly if a services-only partner is to receive a salary but is not supposed to share in losses above the value of those services. Any special allocation of losses (that is, an allocation of any item of loss or any deduction to a partner in a proportion which differs from the ordinary interest of that partner) will have to comply with rigorous requirements imposed by the Internal Revenue Code if it is to be respected for tax purposes. Profit and loss allocations should therefore also be considered by a tax advisor.
10. **Distribution of Profits** - This is not the same as the "allocation" of profits. Profits are allocated for tax purposes in the year the amounts are earned. This is true even if the partners do not see a penny of those earnings during the year in which they are earned and have no expectation of a pay-out in the foreseeable future. When the pay-out does occur, it is called a distribution. The allocation is the taxable event; subsequent distributions are not themselves taxable. However, distributions in advance of the annual allocations may be taxable, which is why most partnership agreements provide for loans, advances or draws against anticipated earnings. This is also a tax-related concept that should be reviewed by a tax professional. In general, a partnership's distribution provisions should cover the schedule or procedures for making distributions; any requirement for establishing reserve funds for partnership expenses prior to distributions; any mandatory distributions; identification of persons with authority to

declare distributions; timing of distributions; any limitations on distribution of profits, and advances or draws made in anticipation of distributions.

11. **Duties of Partners** - A partnership agreement may include a recital of specific responsibilities imposed on partners or the amount of time required of each partner. If partners are authorized to or prohibited from engaging in outside or competing activities, this should also be specified. Especially under the RUPA, this provision may seek to limit or expand the partners' fiduciary duties, such as the duty of care.<sup>104</sup> Such provisions may also include any partnership employee policies, contractual rights and limitations, and the right to or ownership of patents and trade secrets developed in the course of partnership business.
12. **Compensation and Benefits for Partners** - The partners should agree on any salaries that are to be paid to partners and the partners' rights to vacations, holidays, retirement, and other benefits.
13. **Provisions for Expenses of Partners and Partnership** - It is common for the partners to agree upon and designate a depository for partnership funds. The partnership agreement may provide for a responsible party to control income and distribution. One or more partners or other persons may be authorized to negotiate loans and to arrange for their repayment. Alternatively, the agreement may specify a method and time for disbursing payment on indebtedness. Any limitations on indebtedness of partnership should be spelled out.
14. **Management and Control of Business** - If the partnership is to be managed by fewer than all of the partners, the agreement should designate the managing partners or other managers, as well as procedures for their removal and/or replacement. If there are multiple managers, the agreement may cover the division of functions between them. It may also have provisions for partnership business meetings, and spell out any requirements for keeping records of management and control decisions. Any policies that would restrict or limit the managers' authority should also be specified.
15. **Changes in Partners** - A partnership agreement should probably include requirements and procedures governing the admission of new partners and any requirements that may be imposed prior to the acceptance of additional or substitute partners. If there is to be a redistribution of assets upon such changes, the manner in which such redistribution is to occur should be agreed upon. Certain items should also be dealt with to cover the situation of a withdrawing partner. If the other partners are to have the right to expel a partner, this right needs to be in an agreement. The right of a partner to quit or retire should also be explicit. Any limitations and conditions upon voluntary withdrawal should be spelled out as well. The agreement should include provisions relative to the buy-out of a withdrawing partner's interests, including calculation and provision for payment of the buy-out price. The agreement may wish to specify whether and how goodwill is to be considered upon distribution of assets to a withdrawing partner. The agreement may also need to address any reorganization of partnership rights and duties that would be required upon withdrawal of a partner.

---

104. Because fiduciary duties under the UPA are imposed by the courts rather than the statute, it is not clear whether partners are entitled to modify their obligations to the partnership or other partners in a partnership agreement.



16. **Death of a Partner** - This may be dealt with separately from voluntary acts of withdrawal. If so, the agreement may specify provisions relative to the purchase of the decedent partner's interest. The agreement should provide whether death results in dissolution or a presumed continuation of the partnership. It should also consider whether the estate should be allowed to act as partner, and if so, for how long. The agreement should also cover any decedents' rights to receive share of assets or additional income from the partnership.
11. **Sale or Purchase of Partnership Interest** - A partnership agreement should address any right of first refusal or option to purchase held by the remaining partners or other terms relating to the right of a partner to transfer his or her partnership interest. Any limitations on the purchaser of an economic interest should be spelled out, with the understanding that the UPA does not expressly allow such restrictions and the courts may not respect any purported restriction which it deems to be unreasonable. The agreement should also cover any required terms for the sale of partnership interests and the procedures to be followed in reorganizing the partnership following the sale.
12. **Arbitration of Disagreements** - Some dispute resolution mechanism may be desirable, especially in two-person or two-family partnerships where deadlock is possible.
13. **Dissolution and Winding Up** - Most partnership agreements include a listing of the conditions which will lead to dissolution of partnership. This may include events which trigger dissolution by operation of law. Agreements may also consider procedures and time for winding up business, although the statutes include fairly specific and reasonable procedures. If the partnership desires to establish a committee for winding up the partnership business, this should be spelled out in an agreement. Any compensation for committee members should be included in the agreement. Finally, the agreement may or may not cover distribution procedures, which are also fairly well covered in the statutes.

## D. Limited Partnership

### 1. Business Law Status

In most states, limited partnerships are governed by a version of the Revised Uniform Limited Partnership Act, which is usually referred to as the RULPA. Although the RULPA may have been modified by the state legislatures in a variety of ways, there is a great deal of similarity in the way limited partnerships operate, regardless of the state of formation.<sup>105</sup> The information provided in this article tracks the provisions of the uniform act, recognizing that the law in any given jurisdiction may vary somewhat from the rules discussed here.

#### a. Formation

---

105. The official version of the Revised Uniform Limited Partnership Act can be found in volume 6A the Uniform Laws Annotated. This document, however, refers solely to the sections of the uniform act, rather than giving the full official citation. NCCUSL is currently considering an updated version of RULPA, which will change some of the rules described here. Any such provisions would take effect only after a given state enacted the revisions.

A limited partnership is formed by filing a certificate of limited partnership with appropriate state officials.<sup>106</sup> Obviously, this means that an oral agreement will not be sufficient to create a limited partnership. However, the information required to be contained in a certificate of limited partnership is quite limited.<sup>107</sup> Typically, unless the parties wish to abide by the default rules contained in the relevant statutes, the bulk of the agreement between the partners in a limited partnership will be contained in a partnership agreement. The partnership agreement need not be in writing, although there are sound reasons for doing so (such as the ease of proof in the event of a future dispute).

Although the statutory requirements associated with the formation of limited partnerships do not appear to be particularly complex, there are nonetheless a fair number of cases dealing with the issue of what happens when these requirements are not complied with or are complied with only in part. In general, persons who attempt to form a limited partnership but fail to follow the required statutory formalities run the risk that they will be found to have inadvertently created a general partnership, subject to all of the default rules of the UPA or the RUPA, whichever statute controls general partnerships in the subject jurisdiction.<sup>108</sup>

Under the RULPA, a limited partnership is a partnership with at least one general partner and at least one limited partner.<sup>109</sup> A limited partnership is taxed as a partnership and subject to many of the same rules as general partnerships. The biggest distinctions between general and limited partnerships have to do with management rights and limited liability of the limited partners.

#### b. Management of a Limited Partnership

Management of a limited partnership is vested in the general partners.<sup>110</sup> Limited partners do not have management authority. They do, however, have a benefit that the general partners do not possess. Limited partners do not have the unlimited personal liability of general partners.<sup>111</sup> If, however, they assume control over the partnership's business and a third party assumes because of their actions that they are general partners, the limited partners will lose their limited liability as to such third party.<sup>112</sup>

In a change from the first Uniform Limited Partnership Act, the RULPA contains a detailed but non-exclusive list of activities which will not be deemed to amount to "participating in control."<sup>113</sup> Under

---

106. RULPA § 201.

107. RULPA § 201(a).

108. See, e.g., *Dwinell's Central Neon, v. Cosmopolitan Chinook Hotel*, 21 Wash. App. 929, 587 P.2d 191 (1978).

109. RULPA § 101.

110. RULPA § 403.

111. RULPA § 303(a).

112. RULPA § 303(a).

113. RULPA § 303(b).

the terms of this provision, a limited partner will not risk losing the protections of limited liability solely by doing any one or more of the following:

- (1) Being a contractor for or an agent of the limited partnership or of a general partner (including serving as an officer, director, or shareholder of a corporate general partner);
- (2) Consulting with and advising a general partner about the limited partnership's affairs;
- (3) Guaranteeing specific partnership obligations;
- (4) Taking any action to bring or pursue a derivative action in the right of the limited partnership;
- (5) Requesting or attending a meeting of partners;
- (6) Proposing, approving, or disapproving, by voting or otherwise, on any of a number of specified matters which might be considered at a partnership meeting;
- (7) Winding up the limited partnership; or
- (8) Exercising any other right or power permitted to limited partners under RULPA.

The only other way for a limited partner to wind up with unlimited personal liability is to “knowingly permits his name to be used in the name of the limited partnership,” in which case the partner will be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.<sup>114</sup>

#### c. Persons Erroneously Believing Themselves to be Limited Partners

On the other hand, it is clearly possible for someone to believe that he or she is a limited partner when in fact he and she is not. This may occur either because no certificate of limited partnership was properly filed and therefore the limited partnership does not exist, or because the person in question was improperly omitted from the list of limited partners. In either event, the RULPA clearly spells out the consequences for someone who erroneously believes himself or herself to be a limited partner.

The RULPA provides that a person who makes a contribution to a business enterprise and “erroneously but in good faith” believes that he or she has become a limited partner may do one of two things to cut off his or her liability:

- (1) The person in question can file an appropriate certificate of limited partnership or a certificate of amendment; or

---

114. RULPA § 303(d). A limited partner may be liable for the value of any agreed-upon contribution, for debts as to which the limited partner acts as a surety or guarantor, and for debts arising out of the limited partner's personal misconduct. In addition, the veil of limited liability might be pierced, resulting in the imposition of personal liability on all participants, although there appear to be no reported cases holding a passive limited partner liable in this manner.

(2) The person may withdraw from future equity participation in the enterprise by executing and filing in the office of the Secretary of State a certificate declaring such withdrawal.<sup>115</sup>

Once this is done, there is no risk of liability as a general partner to future creditors, although any creditor who transacted business with the enterprise before the partner withdrew or filed the appropriate certificate can hold the partner liable, but only if the creditor “actually believed in good faith that the person was a general partner at the time of the transaction.”<sup>116</sup>

d. Contrasting a Limited Partnership with a General Partnership

In addition, a number of other issues are handled somewhat differently in the statutory rules applicable to limited partnerships rather than general partnerships. First, a limited partnership can only be formed upon the filing of a written document which names the partners.<sup>117</sup> Second, the limited partnership must have at least one limited partner, as well as at least one general partner.<sup>118</sup> Third, unless the partners agree otherwise, profits and losses of a limited partnership are presumed to be allocated on the basis of the value of the contributions made by each partner rather than equally, as would be the case with a general partnership.<sup>119</sup> The RULPA also differs from the uniform partnership acts in that it expressly prohibits distributions that would render the partnership insolvent.<sup>120</sup> In addition, absent agreement to the contrary, while a general partner has the absolute right to withdraw from a limited partnership at any time, the RULPA requires a limited partner to give at least six months’ written notice to each general partner before withdrawing.<sup>121</sup> Moreover, withdrawal of a limited partner does not trigger dissolution, and even withdrawal of a general partner does not necessarily mean that the partnership must dissolve.<sup>122</sup>

e. Dissolution and Termination

The dissolution and termination provisions of the RULPA are rather complicated. Under the terms of the statute and subject to the contrary agreement of the partners, a limited partnership may be judicially dissolved upon the petition of any partner “whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement.” This is permissive, in the sense that a court is empowered to order dissolution rather than being required to do so.

---

115. RULPA §304(a).

116. RULPA § 304(b).

117. RULPA § 201.

118. RULPA § 101(7).

119. RULPA § 503.

120. RULPA § 607. However, any fraudulent transfer law would probably operate in much the same way, so this distinction may be more apparent than real.

121. RULPA § 603.

122. RULPA § 801.

In addition, dissolution of a limited partnership occurs upon the happening of any of the following events:

- i. The arrival of the time specified in the certificate of limited partnership or the happening of events specified in the partnership agreement.
- ii. Written consent of all partners (general and limited, unless otherwise agreed).
- iii. An event of withdrawal of a general partner, unless a provision of the partnership agreement permits any remaining general partners to carry on the business and they do so, or within 90 days after dissolution all remaining partners agree in writing to continue the business and, if necessary or desired, add new general partners. Under the RULPA, the following events amount to withdrawal of a general partner:
  - (A) A general partner resigns, retires, or otherwise quits.
  - (B) A general partner assigns all of his, her or its interest in the partnership.
  - (C) A general partner is removed in accordance with the partnership agreement.
  - (D) Unless the partnership agreement provides otherwise, a general partner takes certain specified steps in the nature of voluntary bankruptcy; e.g., files a voluntary petition, seeks or consents to the appointment of a receiver.
  - (E) Unless the partnership agreement provides otherwise, 120 days after an involuntary bankruptcy proceeding is filed against a general partner, unless it has been dismissed, or 90 days after a trustee or custodian is appointed without the general partner's consent.
  - (F) The death of, or the entry of a decree of incompetency concerning, a general partner who is a natural person.
  - (G) The termination of a trust if the general partner is a general partner because it is trustee of that trust.
  - (H) The dissolution and commencement of winding up of a general partner that is a separate partnership.
  - (I) The filing of a certificate of dissolution or equivalent action by a corporate general partner or the revocation of its charter.
  - (J) The distribution of an estate's interest in the partnership if the estate is a general partner.

As the RULPA makes clear, partners in a limited partnership have a significant degree of flexibility in determining when their limited partnership dissolves. They may specify events at the time they enter into their partnership agreement or later amend it, or they may dissolve it at any time if all of them agree. They may agree that certain events will not cause a general partner to cease to be a general partner, or that the remaining general partners or one or more newly admitted ones will continue the business without dissolution.

With regard to the process of dissolution, unless the partners have managed to avoid winding up by electing to avoid the dissolution as provided in the statute or partnership agreement, the partnership's business and affairs must be wound up upon dissolution. In general, limited partnerships liquidate in the same fashion as general partnerships, except that only the general partners (other than those who wrongfully caused dissolution) ordinarily supervise.<sup>123</sup> Under the RULPA, the partners may

---

123. RULPA § 803.

vary the rules for conducting the liquidation, and if there is no general partner who has not wrongfully caused dissolution, the limited partners may conduct the liquidation. The RULPA also permits partners, their representatives, or their assignees to petition a court to conduct the liquidation. As with general partnerships, limited partnerships continue in existence during the liquidation process, and the general partners and liquidators continue to have fiduciary and other duties to the partnership and other partners.

When one considers the rules applicable to liquidating distributions, it is apparent that the drafters of the RULPA have attempted to adopt default rules that will coincide with the expectations of most persons. Initially, the RULPA is clear that partners, both general and limited, may lend funds to and transact business with a limited partnership on the same basis as third parties. In addition, the priority of payment is relatively simple and approximates what most persons would likely expect. Under normal circumstances, the payout is in the following order of priority:

- i. To creditors, including partners who are creditors other than for distributions required under the partnership agreement but not yet made.
- ii. Except as provided in the partnership agreement, to partners for distributions required in the partnership agreement but not yet made.
- iii. Except as provided in the partnership agreement, to partners first to return capital contributions with any remaining amounts distributed according to how interim distributions are shared.

This approach pays off creditors first, including partner-creditors, and then returns all other amounts to the partners as they may agree, making no distinction between general partners and limited partners. These amounts are not called "liabilities," which should avoid the possible obligation of general partners to make up any deficit.

The final stage of limited partnership dissolution involves cancelling the certificate of limited partnership. The RULPA provides that a certificate of cancellation must be filed on dissolution and the commencement of winding up activities (or if there are no limited partners remaining at any point in time). The certificate must state the reason for the filing, among other things. All general partners must sign this certificate. There are also specific provisions for the notification of creditors.

## **2. Tax Status**

Limited partnerships are among the entities that are entitled to elect whether to be taxed as partnerships or corporations. (One notable exception would be publicly traded limited partnerships, since the Internal Revenue Code separately provides that any publicly held entity is to be taxed as a corporation.)<sup>124</sup> With this exception, however, it is likely that the vast majority of limited partnerships will choose partnership tax status. This means that Subchapter K of the Internal Revenue Code will apply to limited partnerships in much the same way that it applies to general partnerships.

There will, however, be some differences between the way that general partnerships and limited partnerships are taxed, because some rules apply differently to limited and general partners. One of the most notable of these differences, from an income tax perspective, is the different ways that allocations are taxed for purposes of self-employment taxes.

---

124. I.R.C. § 7704.

The Internal Revenue Code imposes a tax on the self-employment income of every individual in order to fund the nation's social security programs.<sup>125</sup> The Code also defines self-employment income as net earnings from self-employment less certain adjustments.<sup>126</sup> Net earnings from self-employment include the gross income earned by an individual from a trade or business conducted by the individual, less deductions attributable to the trade or business, plus the individual's distributable share of income or loss, with certain other adjustments.<sup>127</sup> However, "there shall be excluded [from net earnings from self-employment] the distributive share of any income or loss of a limited partner, as such, other than guaranteed payments<sup>128</sup> . . . to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services."<sup>129</sup>

Under these rules, payments to a limited partner are not subject to the self-employment taxes, unless the distributions are in the form of guaranteed payments such as salary and fees received for services actually performed by the limited partner for the partnership. The distributive shares received as a general partner are treated as self-employment income and subject to employment taxes, and if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would be self-employment income.

Unless the limited partner has some particular interest in being covered by the social security system (which requires payment of a significant level of self-employment taxes), it will be in the interests of the partner to receive payments as distributions other than in the form of guaranteed payments for services. The Code clearly allows this.

In addition, there may be differences in the way that gift tax provisions apply to limited partnerships, particularly with regard to the application of valuation discounts. Limited partners have no right to participate in management, and lack of control is one factor which justifies reducing the value of a limited partnership interest for purposes of estate and gift taxes.<sup>130</sup> This can be an important consideration when estate planning is one of the motivations for forming a business into which to place farming assets.

### **3. Continued Viability of the Limited Partnership**

At one point in time, the limited partnership was a very important option for many businesses. It allowed for centralized management (in the hands of the general partners), limited liability for the passive investors (the limited partners), and partnership taxation. Its most significant drawback was that the general partners, in exchange for the exclusive power to manage the business enterprise, also assumed unlimited personal liability.

---

125. I.R.C. § 1401.

126. I.R.C. § 1402(b).

127. I.R.C. § 1402(a).

128. Guaranteed payments are defined in I.R.C. § 707(c).

129. I.R.C. § 1402(a)(13).

130. I.R.C. § .

There are now other forms of business that will often better achieve the primary advantages once available only with the limited partnership form of business. The LLC in particular allows greater flexibility in achieving limited liability for all participants and tailoring the management structure to the desires of business participants. Moreover, unless a specific election is made, the LLC will be taxed as a partnership despite offering the advantages of limited liability and centralized management (to the extent desired).

The remaining reasons for choosing a limited partnership over the LLC are: (1) familiarity with the limited partnership form of business, particularly where the limited partnership in question can elect to become an LLLP (limited liability limited partnership) and thus give the general partner some protection against unlimited personal liability; (2) ease of understanding and application of partnership tax rules, particularly where the limited partners want to classify their share of income as something other than employment income; (3) accountants may prefer the limited partnership form; (4) the business is already set up as a limited partnership and changing would be inconvenient; (5) expense of formation, since custom-drafting LLC documents is often more expensive than drafting a "standard" partnership agreement for a limited partnership; and (6) estate planning considerations.

Recent searches of business filings reveal a relatively small number of new limited partnerships but a significant volume of LLLP filings in those jurisdictions where such filings are permitted. For this reason, if no other, it is important to consider the rules applicable to limited partnerships, since for the most part these rules will also govern LLLPs.

## **E. Limited Liability Partnerships**

### **1. Business Law Status**

One of the two newest forms of business entity is the limited liability partnership (LLP). The other is the limited liability limited partnership or LLLP, discussed below. All 50 states plus the District of Columbia have enacted LLP legislation, with Wyoming being the last state to do so. Because there was no uniform or model LLP Act when most of these state statutes were enacted, and because there is substantial variation from state to state, the following description of LLPs is even more general in nature than the descriptions of the other available forms of business enterprise discussed in this article. For persons wishing to research the law applicable to LLPs in a given state, the statutes typically appear in the form of amendments to state general partnership laws.

In essence, an LLP is a general partnership where all partners have limited liability as to certain of the partnership's debts. Except for a very few special provisions, it is subject to the same rules as a general partnership.

#### **a. Formation**

One difference between an LLP and a general partnership is the way in which this form of business is created. As discussed previously,<sup>131</sup> no special formalities are required to form a general partnership. Certainly there is no requirement for a written agreement or filed document. On the other hand, an LLP can only be formed by having a general partnership file an application with the appropriate state officials (which means that it is impossible to form an LLP solely with an oral

---

131. See *supra* part C.1. of this article..



agreement). The form which is to be filed typically requires very little information and is akin to the certificate of limited partnership for a limited partnership or articles of incorporation for a corporation. Generally, the document must include the name of the LLP, a registered agent and office address for service of process, and often a general statement that the partnership in question is electing LLP status. Under some state laws, the names of the general partners must also be included. Additional information may also be required under the statutes of any given state.

In some states, the registration must be renewed annually, although most state statutes no longer have an annual registration requirement. In states where annual registration is required, the statute typically provides that the registration as an LLP has a duration of a single year, and a new filing (with additional fees) is required each year. The effect of failure to renew varies from state to state, with some states specifically providing that a failure to renew in a timely fashion will not extinguish the limitation on liability until the Secretary of State or other official notifies the LLP that the registration is expiring. Other states provide that even a late renewal, so long as it is within specified time limits, retroactively reinstates the partnership's status as an LLP. Still other statutes with a renewal requirement are silent on the question of the effect of failure to renew in a timely fashion. Possibly as a result of the potentially disastrous effects of an accidental lapse in registration, at least from the individual partners' perspectives, the trend is clearly towards abandoning an annual renewal requirement.

Filing fees also vary dramatically from jurisdiction to jurisdiction. Some cases involve a flat fee, while in other states the fee imposed depends on the number of partners to be shielded from personal liability. In those jurisdictions with a renewal requirement, the entire filing fee is typically due with each renewal, making this a potentially significant source of state revenue and helping to explain why some states continue to require annual renewals.

In some states there are minimum insurance or financial responsibility provisions in the statute. These states impose a statutory requirement that each LLP maintain insurance covering certain obligations in an amount between \$100,000 to \$1,000,000. The statutes differ as to whether the LLP has the option of maintaining these amounts in a segregated account rather than obtaining outside coverage. Probably because of the impossibility of finding a single minimum insurance requirement that is appropriate for all LLPs, fewer and fewer states are retaining their insurance requirements.

#### b. Limitation on Liability of General Partners

The primary benefit of LLP status is another difference between general partnerships and LLPs. This benefit is that partners in LLPs have no personal liability for certain debts of the entity. The reason for hedging on the description of limited liability in an LLP is that there are two general models of liability in LLPs, and the states are split on the amount of protection from personal liability offered to general partners in such an enterprise.

Early LLP statutes adopted a rule which provided that partners in an LLP would have no liability for obligations arising out of the misconduct of others. "Misconduct" is variously described in the state statutes. Originally, the limitation on personal liability was limited to debts arising out of tortious malfeasance or misconduct by others, as the original LLP statute was designed particularly to protect partners in professional partnerships from personal liability for the malpractice of others.<sup>132</sup> This was

---

132. For a detailed description of the background to the original LLP statute, which was adopted in Texas in 1991, see Robert Hamilton, *Registered Limited Liability Partnerships: Present at the Birth*

quickly expanded to cover liability for the misconduct of others, whether or not sounding in contract or tort, when it was realized that clever plaintiffs' lawyers could avoid the scope of the original statutory language through the simple expedient of framing a complaint in terms of breach of a contractual duty. The statutes generally came to include a list of activities for which the protection against personal liability would exist. Often these statutes provide a limitation on liability arising out of the errors, omissions, negligence, incompetence, or malfeasance of others, sometimes specifically including willful or intentional misconduct. There is no provision in these statutes (which are commonly referred to as first generation or partial shield statutes) that would allow partners in LLPs to avoid personal liability for business debts incurred in the course of ordinary partnership operations.

On the other hand, some states, beginning with Minnesota and including such influential jurisdictions as New York, adopted a much broader limitation on personal liability for partners in LLPs. In these jurisdictions, the statutes (generally referred to as second generation or full shield statutes) provide that a partner in an LLP has no personal liability for debts of the partnership, regardless of how such debts arise. Further encouraging the proliferation of second generation statutes, when the National Conference of Commissioners on Uniform State Laws drafted amendments to the RUPA in 1996 to authorize the formation of LLPs, they elected to include full shield protection in the Uniform Partnership Act. Thus, as states adopt the RUPA, they are more likely to adopt full shield provisions as well.

There is one other potentially significant difference in the statutory language relating to the limitation of liability afforded to partners in LLPs. There are essentially three different ways in which states have addressed the issue of when a partner should be liable for the misconduct of others. This issue arises regardless of whether the state statute in question insulates partners from personal liability for ordinary business debts of the LLP (i.e., is a first or second generation statute), since the question of when partners will be liable for the malfeasance of others is completely independent of the question of whether there should be liability for contractual debts of the enterprise. The first of the three approaches is for the statute to provide that a partner will be liable for the misconduct of those under his or her direct supervision and control. This was clearly the approach taken by most of the early first generation statutes. The second possibility is to adopt an alternative verbal formulation addressing the liability of partners for the misconduct of others. The third option is to enact legislation which simply does not mention the liability for the misconduct of others.

Many LLP statutes include language which makes a general partner liable for the tortious misconduct of those under the partner's "direct supervision and control." This language has appeared in LLP statutes in Arizona, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Virginia, Washington, and West Virginia.<sup>133</sup> Some of these states also imposed additional requirements in order for the "direct

---

(*Nearly*), 66 U COLO. L. REV. 1065 (1995).

133. See, e.g., Ariz. Rev. Stat. Ann. § 29-215 (1995); Conn. Gen. Stat. § 34-53 (1995); Del. Code Ann. tit. 6 § 1515 (1994); Fla. Stat. ch. 620.782 (1996); Idaho Code § 53-315 (1995); Ill. Ann. Stat. ch. 805 para. 15 (Smith-Hurd 1995); Iowa Code § 486.15 (1995); Kan. Stat. Ann. § 56-315 (1994); Mich. Comp. Laws § 449.46 (1995); Mo. Rev. Stat. § 38.150 (1996); Neb. Rev. Stat. § 67-315 (1996); N.H. Rev. Stat. Ann. § 212:5 (1996); Nev. Rev. Stat. § 87.150.2 (1996); N.J. Rev. Stat. § 42:1-15 (1995); N.M. Stat. Ann. § 54-1-15 (1995); N.Y. Partnership Law art. 3 § 26 (1995); Ohio Rev. Code Ann. § 1775.14 (1995); Or. Rev. Stat. Ann. § 68.270 (Michie Supp. 1996); 15 Pa. Cons. Stat. § 8204 (1995); R. I. Gen. Laws § 7-12-26 (1996); S.C. Code Ann. § 33-41-370 (Law. Co-op. Supp. 1994); S.D. Codified Laws § 48-2-15 (1995); Tenn.

supervision and control" language to apply. For example, the Kansas statute provided that the limitation of liability in an LLP does not extend to liability for misconduct of another if the partner was exercising "direct supervision and control at the time the negligence, malpractice, wrongful acts and omissions or misconduct occurred."<sup>134</sup> Similarly, the Virginia statute required that the "direct supervision and control" be in "the specific activity in which the negligence, malpractice, wrongful acts or misconduct occurred."<sup>135</sup> The New York LLP Act provided that liability will exist if a partner was exercising "direct supervision and control while rendering professional services . . . ."<sup>136</sup>

A few statutes use formulations that make the question of when a partner in an LLP will have personal liability for the acts of another turn on something other than "direct supervision and control." The District of Columbia, Maryland, North Carolina, and Texas LLP Acts all fit into this category. The Maryland statute says that a partner will have personal liability for the acts of another "if the partner is negligent in appointing, directly supervising, or cooperating with the other . . . ."<sup>137</sup> The North Carolina statute says that a partner is insulated from personal liability for the misconduct of another "unless the first partner was directly involved in the specific activity . . . ."<sup>138</sup> The District of Columbia and Texas, upon which the District of Columbia clearly relied in drafting its statute, have the most complicated statutory provisions. Statutes in these two states provide for limited liability:

unless the first partner:

- (a) was directly involved in the specific activity in which the errors, omissions, negligence incompetence, or malfeasance were committed by the other partner or representative; or
- (b) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance of the other partner or representative at the time of occurrence.<sup>139</sup>

A third group of state statutes omit any reference to potential liability for the acts of others. These states include California, Colorado, Georgia, Indiana, Kentucky, Louisiana, Minnesota, North Dakota, and Utah.<sup>140</sup> This does not mean that partners in an LLP in such jurisdictions will have no

---

Code Ann. § 61-1-114 (1996); Va. Code Ann. § 50-15 (1995); Wash. Rev. Code § 25.04.730 (1996); W. Va. Code § 47B-3-6 (1996).

134. Kan. Stat. Ann. § 56-315 (1994).

135. Va. Code Ann. § 50-15 (1995).

136. N.Y. Partnership Law art. 3 § 26 (1995).

137. Md. Code Ann. § 9-307(c) (1996).

138. N.C. Gen. Stat. § 59-45 (1994).

139. D.C. Code Ann. § 41-146 (Supp. 1995); Tex. Rev. Civ. Stat. Ann. art. 6132b § 15 (1995).

140. Cal. Corp. Code § 151015 (1996); Colo. Rev. Stat. § 7-60-115 (1996); Ga. Code Ann. § 14-18-15 (1995); Ind. Code § 23-4-1-15 (1996); Ky. Rev. Stat. Ann. § 362.220 (Baldwin 1995); Ind. Code § 23-4-1-15 (1996); La. Rev. Stat. Ann. § 3431 (1995); Minn. Stat. § 323.14 (1995) (as amended by 1995 Minn. Sess. Law Serv. ch. 58 (S.F. 1042) (West); Utah Code Ann. § 48-1-12 (1995).

liability for the misconduct of others. Certainly, if a partner has a duty to supervise or control another person and is personally negligent in performing those supervisory functions, liability should exist, regardless of a specific statutory provision in the LLP Act discussing personal liability for the acts of others. The exact extent of personal liability for partners in LLPs is pure speculation, however, since there are currently no reported decisions dealing with this issue in the context of LLPs under any of the various statutory models.

In addition, none of the existing statutory models offer much guidance about what was intended as to precisely when a partner should be personally liable for the misconduct of others in the partnership. For example, LLP statutes that use the phrase "direct supervision and control" offer no definition of this language. In fact, none of the state LLP acts include any explanation of how to interpret the applicable statutory language concerning when a partner in an LLP will be liable for the acts of another.<sup>141</sup>

#### c. Comparing an LLP to a General Partnership

The foregoing discussion points out only four primary differences between LLPs and general partnerships: they are formed in different ways; they may have different requirements concerning insurance or financial responsibility; specific steps may need to be taken in order to maintain LLP status; and the liability of general partners is significantly different.

Aside from these differences, the statutory rules applicable to general partnerships also apply to LLPs. Thus, all partners will have equal management authority unless otherwise agreed, and even with agreement to the contrary, all partners retain apparent authority to bind the partnership by acts which are apparently carrying on the usual business of the partnership. The default rule under both the UPA and the RUPA is that all partners have equal rights to share in profits and losses of the enterprise. Under the UPA, withdrawal of any partner triggers dissolution of the partnership and only if the withdrawal is made wrongful by agreement will the remaining partners have the right to continue the business. Under the RUPA, withdrawal of a partner triggers dissolution and winding up unless the parties have agreed to a particular term or undertaking for the business, have otherwise agreed that the partners have no right to withdraw, or the remaining partners make a timely election to continue the business.<sup>142</sup>

As a practical matter, perhaps the most significant disadvantage to the LLP as compared to the general partnership form of business is the relative novelty and unfamiliarity of the LLP. This means that relatively little has been written about them, although this is changing as the LLP gains in popularity. However, in most states, there are still relatively few guide books or other resources to help people become familiar with this form of business organization.

#### d. Choice of Law Problems

Another problem associated with the fact that LLPs are so new is the uncertainty about which state's law will apply. This matters because of the significant variation from state to state in terms of

---

141. For a more detailed discussion of what the phrase "direct supervision and control" might mean in this context, see Carol Goforth, *Limiting the Liability of General Partners in LLPs: An Analysis of Statutory Alternatives*, 75 OR. L. REV. 1139 (1997).

142. Again, for a more detailed examination of the rules applicable to general partnerships under the UPA or RUPA, see *infra* part D.1. of this article..

requirements for formation of LLPs and the extent of the partners' protection against personal liability for partnership debts. Although more and more states appear to be electing the second generation approach, at the current time the states are clearly divided between the two models of liability for partners in LLPs. What happens when an LLP conducts business in a state with a different liability model than in the LLPs' state of formation?

Obviously, there is unlikely to be any problem if the state of formation offers only limited protection against personal liability (i.e., is a first generation state). In this case, the second state and the parties located there are unlikely to be unhappy with the prospect of greater personal liability for the partners, and the partners are unlikely to be in a position to complain since they have formed a business under those terms. However, if an LLP is formed in a state that offers full shield protection, and then conducts business in a state that does not recognize the full scope of such protections for domestic LLPs, there may be room for disagreement in the event of a breach of contract or other contractual default.

The liability in question would have to be something other than that arising out of misconduct or malpractice, because under either type of LLP statute, liability for this type of debt would be limited. But what if the LLP that is formed in a second generation state enters into a contract with a party from a state that has only a first generation LLP statute? Suppose further that the LLP defaults. Are the partners personally liable? Under the laws applicable in the state where the LLP was formed, the partners would not be liable. On the other hand, under the laws applicable in the state where the creditor is located, partners in an LLP are liable for such debts.

Ideally, the creditor would take care of this potential problem in advance by insisting on personal guarantees from the partners if personal liability of the partners is important. However, if the creditor is in a jurisdiction where partners have always had and continue to have such personal liability as a matter of law, this may simply not occur to them. What then?

Two Rhode Island practitioners, writing about this issue in their state bar journal, recently opined as follows:

LLPs which propose to do business in many states, or more dramatically in every state, could be subjected to a permanent identity crisis and more importantly could be left guessing on a case-by-case basis as to whether or not the partners might be subjected to personal liability, to statutory penalties and sanctions for unauthorized business transactions or unauthorized practice, or to both.<sup>143</sup>

There is very little authority on this issue. An LLP doing business in multiple jurisdictions will be well advised to check carefully with legal advisors in each such state, because many states have statutory provisions specifically applicable to foreign LLPs wishing to do business in the state.

## **2. Tax Status**

---

143. Stephen M. Brusini and Stephen D. Zubiago, *Crossing the Border – The Use of Limited Liability Partnerships in Interstate Commerce*, 47 R.I. B.J. 9 (Ap. 1999).

Because an LLP is really only a general partnership that has elected special status for its general partners, LLPs should be taxed just like general partnerships.<sup>144</sup> That discussion will not be repeated here.

## **F. Limited Liability Limited Partnerships**

### **1. Business Law Status**

#### **a. Statutory Authorization for LLLPs**

A minority of states have also adopted statutes which expressly authorize the formation of limited liability limited partnerships (LLLLPs).<sup>145</sup> An LLLP or limited liability limited partnership is a limited partnership where the general partner has the same protections against personal liability that a general partner in an LLP possesses. In states that have an LLLP statute, this form of business enterprise is clearly authorized. In other states, the authority is less than clear.

The question is whether other states have authorized the formation of LLLPs by implication in their LLP statutes. In some states where the LLP legislation takes the form of an amendment to existing partnership law, an argument can and has been made that statutory references to "partnership" law includes limited partnership law, and therefore by implication, partners in limited partnerships in such states ought to be able to gain the protections from unlimited personal liability provided in the LLP legislation.

Prior to the RUPA, there were explicit linkage provisions in both the uniform limited and general partnership acts, and because these statutes had been so widely adopted, the same linkages appeared in the laws of most states. The UPA states that a limited partnership is not a partnership but provides that the UPA "shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith."<sup>146</sup> the RULPA similarly defines a limited partnership as a "partnership,"<sup>147</sup> and further specifies that "[i]n any case not provided for in this [Act], the provisions of the [UPA] govern."<sup>148</sup> Using these cross-references, it is possible to make the argument that since a general partner in a general partnership is entitled to limited liability, general partners in a limited partnership should also be entitled to the limited liability if an appropriate election is made. This

---

144. See *supra* part C.2. of this article for further discussion of this issue.

145. See, e.g., Ariz. Rev. Stat. Ann. § 29-367; Ark. Code Ann. § 4-42-706; Colo. Rev. Stat. Ann. § 7-62-1104; 6 Del. Code § 17-214; West's Fla. Stat. Ann. § 620.187; Iowa Code Ann. § 4878.1301; Md Code, Corps & Assoc., § 10-805; Minn. Stat. Ann. § 322A.88; Vernon's Ann. Mo. Stat. § 358.510; West's N.C. Gen. Stat. Ann. § 59-210; N.D. Cent. Code §§ 45-23-01 to -08; S.D. Cod. Laws § 48-7-1106; Tex. Civ. Stat. Ann. 6132a-1 sec. 2.14; Va. Code Ann. § 50-73.78.

146. UPA § 6(2).

147. RULPA § 101(7).

148. RULPA § 1105.

argument is much harder, and perhaps impossible, under the RUPA, which not only does not explicitly provide for linkage but also defines "partnership" to exclude limited partnerships.<sup>149</sup>

Until there is a judicial determination in each state that LLP legislation implicitly authorizes LLLPs, the legality of LLLPs is certain only in those states which have statutes expressly addressing this form of entity.

b. Characteristics of the LLLP

Assuming that the LLLP is authorized or at least recognized in a given jurisdiction, what are the characteristics of this form of business enterprise? With the exception of registration requirements, the requirement that every LLLP contain some indication in its name that it is an LLLP, and the change in the personal liability of the general partner(s), an LLLP is virtually indistinguishable from a limited partnership under state law.

In fact, the only significant differences are the same differences that distinguish between a general partnership and an LLP: the new provisions relating to filing of a registration statement and renewals thereof, insurance requirements, and limited liability for general partners.<sup>150</sup> Obviously, the name of an LLLP would be slightly different from the name of an LLP as well. In those states where the LLLP is expressly recognized, the statutes will set forth the requirements for filing an election to register as an LLLP. For the most part, those provisions track the applicable requirements of registering as an LLP, although the name of the LLLP is subject to slightly different requirements and limitations.

With regard to the effect of electing LLLP status, a limited partner in a limited partnership is already insulated against personal liability for debts of the partnership (unless the limited partner participates excessively in the control of the partnership), but a limited partnership must also have at least one general partner. Therefore, the advantage of being an LLLP is that the general partner(s) of the limited partnership will be insulated from personal liability, either arising out of the tortious misconduct of others or from any entity level debt, depending on the statutory language used. Other than that, an LLLP is much like an LLP, except that the basic structure is that of a limited partnership rather than a general partnership.

There is one other issue which will potentially apply differently to LLLPs and LLPs: how will states lacking an LLLP statute react to this form of business? As discussed previously, there are potential issues which arise in connection with LLPs that operate beyond the borders of a given state simply because the rules applicable to the liability of partners in those ventures may differ from place to place. However, every state at least recognizes that basic form of business. This is not the case with the LLLP. Some states do not provide for LLLPs at all, so there is at least the potential issue of how an LLLP will be treated if it does business with or interacts with persons from other states, particularly those that do not have such a form of business.

Principles of comity and the full faith and credit clause of the United States Constitution provide some support for the notion that an election among parties to a partnership agreement to be governed

---

149. RUPA § 101(4).

150. For a discussion of the differences between general partnerships and LLPs, see *supra* part E.1. of this article..

by the laws of one state should be respected in another state. In the context of the LLLP, this would carry with it the benefits of the limitation on a partner's liability contemplated by the election of LLLP status. However, the ordinary rules applicable to any conflict of law issue might or might not support the rule of law of one state over that of another, lending to the considerable uncertainty which is associated with this form of business, at least in situations where interstate operations are contemplated.

## **2. Tax Status**

LLLPs should be taxed in the same way as limited partnerships.<sup>151</sup>

## **3. Is the LLLP a Viable Alternative?**

Relatively few states have adopted LLLP statutes, potentially signaling a belief on the part of some that this form of enterprise is unnecessary or undesirable. There is also considerable uncertainty surrounding this form of enterprise, given that it is not at all clear that all states will recognize a limitation on liability established by a statute which has no parallel in the state in question. Given these two facts, it is certainly worth considering whether there are reasons for businesses to choose this option when organizing their business.

One potential advantage relates to the familiarity factor as a matter of state law. Because the LLLP is basically grafted onto the limited partnership statute, most of the rules applicable to this form of enterprise have been around for some time. While this statement used to be equally applicable to LLPs, the spread of the RUPA makes this less true now than in recent history because the RUPA has made some sweeping changes in the law applicable to general partnerships. A similar revision to the RULPA is currently underway but has not yet influenced state law. Thus, the LLLP is a very familiar form of business that offers all owners at least some protection against personal liability. In second generation states with LLLP statutes, this is full shield protection and may make the LLLP particularly attractive, especially for businesses that plan to operate only in-state. The LLC has been in existence for a far shorter period of time, and because of the considerable variation between state laws, there is far less written to guide practitioners.

The familiarity factor is likely to be the most significant for existing businesses with a history of operating as a limited partnership, especially those that wish to retain the same structure and organization, and even the collegiality implicit in having "partners." However, as the LLC becomes more common and better understood, and as RUPA becomes more entrenched, the perceived advantages offered because the limited partnership form is more familiar should diminish.

The familiarity factor also applies when the treatment of LLLPs under the Internal Revenue Code is compared with the treatment of LLCs under those same rules and regulations. The I.R.S. has had a number of years in which to consider the circumstances under which businesses organized under state partnership statutes will be classified as partnerships for federal tax purposes rather than as associations taxable as corporations. In contrast, LLCs are a relatively new form of business enterprise, and there are a number of issues relating to the taxation of LLCs that have not been fully addressed. There are two such rules which may favor the choice of LLLP. One relates to the requirements for discounts on valuation, most useful in the estate planning context. These rules are far more developed in the context of limited partnerships than for LLCs. Similarly, the limited

---

151. See *supra* part D.2. of this article..



partnership and, thus the LLLP, offers greater flexibility in avoiding employment taxes on distributions to limited partners, because the applicability of the self-employment tax provisions to LLCs is still uncertain. Thus, the tax regulations and rulings, which are currently more complete for partnerships (and particularly limited partnerships) than for LLCs, provide one reason why an entity might prefer to be organized as an LLLP. However, as the I.R.S. has increased opportunities to consider LLCs and the application of its rules and regulations to such entities, this advantage is also likely to diminish.

In addition to these income tax consideration, when it comes to reducing the value of interests in a business for estate or gift tax purposes, the LLLP may be particularly attractive. Because limited partners have both limited rights to manage and limited rights to transfer their ownership interest, the I.R.S. currently recognizes and allows certain discounts to be applied when valuing such interests. This may be especially important where a business is being formed for estate planning purposes, since it may be possible to significantly reduce or even avoid estate and gift taxes by reducing the value of particular ownership interests.

There is also one other potential tax advantage to LLLPs as compared to LLCs, at least in certain states. Many states impose business taxes or franchise taxes on corporations and other forms of businesses that offer corporate characteristics such as limited liability. Many of these taxing statutes specifically exclude partnerships, and presumably LLLPs, from their ambit. Thus the avoidance of such state taxes may be another reason in favor of the LLLP format.

While this is not intended to be an all-inclusive listing of the potential advantages of LLLPs, this discussion should help explain why the LLLP is, in fact, utilized in those jurisdictions where it is recognized.

## **G. Conclusion To Part I**

These materials focus only on the sole proprietorship, the general partnership, the limited liability partnership (LLP), the limited partnership, and the limited liability limited partnership (LLLPL). Part II in this series will address the limited liability company (LLC) and the corporation.

These materials should make it clear that each of these forms of business offer some advantages and at least some disadvantages. In any given case, some of these options will not be available or will clearly be less desirable than other alternatives. Although the general partnership is more familiar than the LLP and the limited partnership more familiar than the LLLP, the limited liability enterprises are more likely to have advantages which outweigh this consideration in most situations. Thus, it is not surprising that a great many of the businesses being formed today are organized as LLPs, LLLPs, LLCs or corporations (which are still very popular).

Although these materials focus on the default rules under state law and the possible variations from those rules, when it actually comes to choosing and forming a business out of which to run an agricultural operation, there are likely to be a number of issues that go beyond what is technically possible under state law. The expense of formation or of customization should not be overlooked. Some of these forms of organization are likely to work well only if experienced legal counsel assists in the preparation of written documentation, and this could be costly. Moreover, there are tax and accounting considerations which may also be important in choosing an optimal format for an agricultural (or any other) enterprise.

*This article was prepared in July, 2002.*

*This material is based on work supported by the U.S. Department of Agriculture under Agreement No. 59-8201-9-115. Any opinions, findings, conclusions or recommendations expressed in this article are those of the author and do not necessarily reflect the view of the U.S. Department of Agriculture.*

NCALRI is a federally funded research institution located at the University of Arkansas School of Law  
Web site: [www.NationalAgLawCenter.org](http://www.NationalAgLawCenter.org) • Phone: (479)575-7646 • Email: [NatAgLaw@uark.edu](mailto:NatAgLaw@uark.edu)

The National Agricultural  
Law Center



*A research project from The National Center for Agricultural Law Research and Information of the University of Arkansas School of Law • NatAgLaw@uark.edu • (479) 575-7646 • www.NationalAgLawCenter.org*

---

## **An Agricultural Law Research Article**

# **Part II: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises**

by

Carol R. Goforth

**The National Agricultural Law Center**  
University of Arkansas School of Law  
1 University of Arkansas  
Fayetteville, AR 72701

July 2002

## Part II: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises

### Table of Contents

A.	Introduction to Part II .....	3
B.	Limited Liability Companies .....	4
1.	Business Law Status .....	4
a.	Formation .....	5
b.	The Operating Agreement .....	6
c.	Liability of Members .....	7
d.	Contributions to an LLC .....	8
e.	Management of the LLC .....	8
f.	Allocations of Profits and Losses, and Distributions .....	11
g.	Transferability of Membership Interests .....	13
h.	Terminating Membership Status .....	14
i.	Dissolution, Winding Up and Termination .....	15
2.	Tax Status .....	16
a.	In General .....	16
b.	Basis Adjustments .....	17
c.	The “at-risk” Rules .....	17
d.	Passive Losses .....	18
e.	The “Tax Matters” Partner .....	18
f.	Self-Employment Taxes .....	19
3.	Comparing the LLC with Other Organizational Forms. ....	22
C.	Corporation .....	25
1.	Business Law Status .....	25
a.	Traditional Corporation .....	25
b.	Statutory Close Corporation .....	26
c.	Formation .....	28
d.	Contributions .....	28
e.	The Limits on Shareholder Liability .....	29
f.	Management of a Corporation .....	31
g.	The Rights of a Shareholder to Recognize a Return on the Investment .....	32
h.	Transferability of Shares .....	33
i.	Termination of the Corporation .....	34
2.	Tax Status .....	35
a.	S Corporation .....	35
b.	C Corporation .....	36
D	Cooperatives .....	37
1.	Business Law Status .....	37
a.	Introduction .....	37
b.	General Comparison with the Corporate Form of Business .....	37
c.	The Essential Attributes of the Traditional Cooperative .....	39

d.	Ownership and Control of a Cooperative .....	40
e.	Income Distribution in a Traditional Cooperative .....	41
f.	Returns on Ownership Capital Are Limited .....	43
g.	Traditional Financing for Cooperative Operations .....	44
h.	Value-Added or Next-Generation Cooperatives .....	45
2.	Tax Status .....	50
E	Conclusion to Part II .....	52

# An Agricultural Law Research Article

## **PART II: AN OVERVIEW OF ORGANIZATIONAL AND OWNERSHIP OPTIONS AVAILABLE TO AGRICULTURAL ENTERPRISES**

Carol R. Goforth\*

### **A. Introduction to Part II**

This article is the second of two articles that together are designed to provide an overview of the available organizational choices for persons interested in owning and operating an agricultural enterprise. This article will cover limited liability companies, corporations, and cooperatives. The first document in the series examined sole proprietorships, general partnerships, limited liability partnerships (LLPs), limited partnerships and limited liability limited partnerships (LLLLPs).

As with the first article in this pair of articles, the information provided here is general in nature, and this article does not purport to address the specific rules which apply to each of the options in each of the 50 states. For example, all 50 states have statutes governing the formation and operation of limited liability companies. However, there is considerable variation between the states, so it is difficult to identify specific rules that will apply to every LLC. However, there are general principles which apply to most LLCs, and for most rules there are a limited number of default positions identified in the various state statutes. This article therefore attempts to identify the majority rule and the more prevalent deviations from this position. No attempt has been made to research the law of all 50 states, or to provide citations to all 50 statutes. Rather, as to most issues, the citations provided are to the Uniform or Model Act: in the case of LLCs, the citations are to the Uniform Limited Liability Company Act (U.L.L.C.A.), and for corporations, the citations are to the Model Business Corporation Act (M.B.C.A.). This article therefore focuses primarily on the general rules, even as to corporations, where there is significantly greater uniformity with regard to most of the issues discussed in the following pages.

This article is not intended as a substitute for the advice of experienced counsel familiar with the laws of the jurisdiction or jurisdictions in which any proposed agricultural business might operate. The purpose here is to provide general background information, and to offer sufficient insights so that a reader will be able to understand most of the attributes of the business forms discussed here.

Because it is possible that this article may be consulted by attorneys as well as those who do not have a legal background, the text will generally be written in a manner which is intended to be understandable by anyone. Footnotes will contain more detailed information and citations that are likely to be of interest primarily to persons who already have a legal background, even if their normal areas of expertise do not include the law applicable to business enterprises.

---

\* Clayton N. Little Professor of Law, University of Arkansas

Neither part of this series addresses non-profit organizations or trusts, even though both of these may be employed in connection with certain agricultural operations. Rather, the focus of these materials is on the business forms listed above. As with Part I of this series, both business and tax considerations will be introduced, although the primary focus of this article is on the business law rules applicable to each of the organizational forms considered here.

## **B. Limited Liability Companies**

### **1. Business Law Status**

The LLC is a creature of statute, recognized in each jurisdiction only by virtue of a legislative enactment. The first statute authorizing domestic LLCs was passed in Wyoming in 1977.<sup>1</sup> When the I.R.S. finally concluded in 1988 that limited liability should not be a determinative factor in denying partnership tax status to the new organization, the LLC began to receive significant attention elsewhere.<sup>2</sup> Shortly after determining that limited liability would not be a determinative factor in entity classification, the Service issued a public ruling concluding that LLCs organized under the Wyoming LLC Act would be classified as partnerships for federal tax purposes.<sup>3</sup> This I.R.S. ruling resulted in a trickle of new legislation which turned into a virtual flood of statutes authorizing the new form of business entity by the early 1990's. In the spring of 1996, the last two states enacted LLC legislation, so that all fifty states, plus the District of Columbia, now permit the formation of LLCs.<sup>4</sup>

---

1. Wyo. Stat. §§ 17-15-101 to -136 (1989 & Supp. 1995).

2. Announcement 88-118, 1988-38 I.R.B. (Sept. 19, 1988). This study concluded that the limited liability aspect of LLCs should not, by itself, prevent an LLC from being classified as a partnership for tax purposes. See Turlington & Small, *Tax Aspects of Limited Liability Companies*, PLI Corporate Law and Practice Course Handbook Series, 805 PLI/Corp. 103 (Feb. 1, 1993). Despite the importance of this conclusion, however, there does not appear to have been any written report or analysis accompanying the simple release which did little more than state the conclusions reached by the Service.

3. Rev. Rul. 88-76, 1988-2 I.R.B. (Sept. 18, 1988).

4. Colorado and Kansas enacted LLC statutes in 1990. Colo. Rev. Stat. §§ 7-80-101 to 7-80-1101 (Supp. 1995); Kan. Stat. Ann. §§ 17-7601 to 17-7656 (1995). Nevada, Texas, Utah and Virginia followed suit in 1991. Nev. Rev. Stat. §§ 86.011 to 86.571 (1991); Tex. Rev. Civ. Stat. Ann. art. 1528n §§ 1.01 to 11.07 (West Supp. 1996); Utah Code Ann. §§ 48-2b-102 to 48-2b-158 (Supp. 1996); Va. Code Ann. §§ 13.1-1000 to 13.1-1073 (1993 & Supp. 1996). In 1992, ten more states passed statutes authorizing LLCs. Ariz. Rev. Stat. Ann. §§ 29-601 to 29-857 (Supp. 1995); Del. Code Ann. tit. 6, §§ 18-101 to 18-1107 (1993 & Supp. 1996); Ill. Ann. Stat. ch. 805 ¶¶ 180/1-1. to 180/60-1. (Smith-Hurd Supp.1996); Iowa Code Ann. §§ 490A.100 to 490A.1601 (West Supp. 1996); La. Rev. Stat. Ann. §§ 12:1301 to 12:1369 (West 1994); Md. Code Ann., Corps. & Ass'ns, §§ 4A-101 to 4A-1103 (1993); Minn. Stat. Ann. §§ 322B.01 to 322B.960 (West 1995 & West Supp. 1996); Okla. Stat. Ann. tit. 18, §§ 2000 to 2060 (West Supp. 1996); R.I. Gen. Laws §§ 7-16-1 to 7-16-75 (1992 & Supp.1995); W.Va. Code §§ 31-1A-1 to 31-1A-69 (1996).

In 1993 the following jurisdictions enacted LLC legislation: Ala. Code §§ 10-12-1 to 10-12-61 (Supp. 1995); Ark. Code Ann. §§ 4-32-101 to 4-32-1316 (Michie 1996); Conn. Gen. Stat. Ann. §§ 34-100 to 34-242 (West Supp. 1996); Ga. Code Ann. §§ 14-11-100 to 14-11-1109 (1994 & Supp. 1996); Idaho Code §§ 53-601 to 53-672 (1994 & Supp 1996); Ind. Code Ann. §§ 23-18-1-1 to 23-18-13-1 (Burns 1995 & Burns Supp. 1996); Mo. Ann. Stat. §§ 347.010 to 347.740 (Vernon Supp. 1996); Mich. Comp. Laws Ann. §§ 450.4101 to 450.5200 (West Supp. 1996); Mont. Code Ann. §§ 35-8-101 to 35-8-1307 (1995); Neb. Rev. Stat. §§ 21-2601 to -2645

a. Formation

An LLC is formed by filing an organizational document, often called "Articles of Organization," with the Secretary of State or other appropriate official.<sup>5</sup> These articles perform a similar function and contain similar information to articles of incorporation or a certificate of limited partnership. Like its corporate and limited partnership counterparts, the articles for an LLC contain relatively little information. Most states will have standard forms that can be used for this purpose and can usually be obtained from the office of the secretary of state or similar official. The actual date of formation may be when articles complying, with the applicable statute or, in some cases, substantially complying are received by the appropriate state official or, in other cases, when the document is actually filed. In most states a later effective date is also possible.<sup>6</sup>

In every state the articles must include the name of the LLC. The name of a nonprofessional LLC may generally not be the same as or deceptively similar to the name of any other LLC, limited partnership, or corporation organized in or transacting business in the state where the LLC is to be formed or to a name that has previously been reserved by someone else. In most states, the name of a nonprofessional LLC must contain the words "Limited Liability Company" or "Limited Company" or the abbreviations for those terms.<sup>7</sup>

In most states there is no express limitation on the use of a member's name in the LLC, as there is with respect to the use of a limited partner's name in the limited partnership. The use of the limited partner's name may open up that limited partner to potential personal liability to creditors of a limited partnership. The absence of a similar limitation in the LLC acts on the use of a member's name is simply another illustration of the potential differences in the roles of the limited partners and the LLC members in the management of the respective entities.

---

(Supp. 1995); N.H. Rev. Stat. Ann. §§ 304-C:1 to 304-C:85 (1995); N.J. Stat. Ann. §§ 42:2B-1 to 42:2B-70 (West Supp. 1996); N.M. Stat. Ann. §§ 53-19-1 to 53-19-74 (Michie 1993 Repl. & Cum. Supp. 1996); N.C. Gen. Stat. §§ 57C-1-01 to 57C-10-07 (1993 & Supp. 1995); N.D. Cent. Code §§ 10-32-01 to 10-32-155 (1995); Or. Rev. Stat. §§ 63.001 to 63.990 (Supp. 1994); S.D. Codified Laws Ann. §§ 47-34-1 to 47-34-59 (Supp. 1996); Wis. Stat. Ann. 183.0102 to 183.1305 (West Supp. 1995).

In the next three years, the remaining states enacted LLC statutes. See Alaska Stat. §§ 10.50.010 to .995 (Michie Supp. 1995); Calif. [Corporations] Code §§ 17000 to 17705 (West Supp. 1996); D.C. Code Ann. §§ 29-1301 to -1375 (1996); 1995 S.B. No. 2723 (Hawaii) (enacted 6-7-96); Ky. Rev. Stat. Ann. §§ 275.001 to .455 (Michie Supp. 1994); Me. Rev. Stat. Ann. tit. 31 §§ 601 to 762 (1996); Mass. Gen. L. ch.156C §§ 1-68 (Law. Coop. Supp. 1996); Miss. Code Ann. §§ 79-29-101 to 79-29-1204 (Cum. Supp. 1995); N.Y. Limited Liability Company Law §§ 204 to 1309 (1995); Ohio Rev. Code Ann. §§ 1705.01 to .58 (1995); 15 Pa. Cons. Stat. §§ 8901 to 8998 (1995); Tenn. Code Ann. §§ 48-201-101 to -248-606 (Michie Supp. 1995); 1995 H.B. 112 (Vermont) (enacted 5-22-96); Wash. Rev. Code §§ 25.15.005 to .902 (1996).

Obviously, it would be a significant undertaking to refer to each of these state laws as to every issue discussed here, and likely to lead to more confusion than anything else. Therefore, the following materials recite the general rule, and offers citations only to the Uniform LLC Act, which was promulgated by the N.C.C.U.S.L. too late to be influential in the initial wave of LLC statutes, but which is being considered in a number of jurisdictions as they move to update their statutes.

5. U.L.L.C.A § 202(a) & (c).
6. U.L.L.C.A § 202(b).
7. U.L.L.C.A § 105.



Another universal requirement is that the articles include the name and address of the LLC's registered agent for service of process in the state.<sup>8</sup> A registered agent may generally be an individual who is a resident of that state or a business entity formed in the state, and is, in either case, authorized to accept service of process for the LLC. In most jurisdictions, the address given may be the agent's business, residence, or mailing address, but not a post office box.

In many states, the agent must acknowledge and accept appointment as agent, although this is not a universal requirement. Even in states that include this requirement, the acceptance by the agent typically need not be included in the articles. A separate signed document will work just as well, although many state statutes specifically provide that the LLC cannot be validly formed until such an acceptance is received by the state official.

Another typical requirement is that the articles include the address of the registered office of the LLC.<sup>9</sup> In most states, the LLC is required to continuously maintain a registered office in the state that may, but need not, be the same as the place of business of the LLC. Because many statutes require certain minimal records to be kept at this office and available for inspection, most states require the address to include street and location rather than a post office box.

In a few states, the articles must include other information such as the general purpose for which the LLC is to be formed or the latest date on which the LLC is to dissolve.<sup>10</sup> Optional provisions are usually allowed as well, so long as they are not inconsistent with the requirements of the applicable statute.

In most states the articles may be signed by one or more persons who need not be members of the LLC.<sup>11</sup> The term "persons" for this purpose is liberally defined in the LLC statutes to include individuals, partnerships, other LLCs, trusts, estates, associations, corporations, other legal entities, and custodians and nominees.<sup>12</sup> Often the statute will include specific information requirements such as the address of any person organizing the LLC or the capacity in which any individual signs the document.<sup>13</sup>

#### b. The Operating Agreement

Notwithstanding the requirement that each LLC be formed via the filing of articles, the heart of the LLC is the "operating agreement," which generally governs the conduct of the business and affairs of the LLC.<sup>14</sup> Some state statutes require a written operating agreement. In most jurisdictions,

---

8. U.L.L.C.A § 203(a)(3).

9. U.L.L.C.A § 203(a)(2).

10. U.L.L.C.A § 203(a)(5).

11. U.L.L.C.A § 202 contains no requirement that signatories of the organizational document be members of the LLC.

12. U.L.L.C.A § 101(14).

13. U.L.L.C.A § 203(4).

14. U.L.L.C.A § 103(a).

however, an operating agreement is optional and is only required if the members wish to vary the default rules provided for in the state statutes. Moreover, most state statutes permit the operating agreement to be oral, although there is certainly some variation on this point.

The interrelationship of the operating agreement and the provisions of the LLC legislation is probably most akin to that between a limited partnership agreement and the statutory provisions of the limited partnership act. The statutes provide rather complete models for the LLC and the limited partnership, but are, in a variety of places, expressly made subject to a different agreement of the parties. With respect to many issues, an operating agreement will probably simply incorporate, either expressly or impliedly, the default provisions of the applicable LLC Act. However, significant flexibility is usually allowed the parties to vary the statutory default approach by agreement.

### c. Liability of Members

There are three principle aspects of the LLC that most commentators agree are behind the increasing popularity of the LLC as a choice for new businesses:

(1) it can be taxed as a partnership (or disregarded as a separate entity if there is only a single member);<sup>15</sup>

(2) it is an extremely flexible form of business both in terms of options when creating the business and options about how it is to operate; and

(3) it offers all members limited liability.<sup>16</sup>

Under the default rules of every state, members of an LLC have no personal liability solely because of their status as a member. They will, however, be liable for the amount or value of any agreed-upon contributions,<sup>17</sup> for any debt they have guaranteed or for which they have otherwise agreed to act as surety, and for any personal misconduct in which they engage.

Presumably, members of an LLC will also be liable if the veil of limited liability is pierced, a concept that originally developed in the context of corporate-shareholder liability but that has recently been applied to the LLC context in certain circumstances.<sup>18</sup> In all probability, the risk of liability in this situation is greatest when the LLC is grossly undercapitalized from the outset, and the members act in a manner which is inconsistent with the recognition of the LLC as a separate entity (such as by commingling personal and business funds, failing to document loans to and from the entity, and the like). Such facts would tend to show that the members have treated the LLC as their “alter-ego,” rather than as a distinct legal entity, or that the LLC serves as an instrumentality by which the members are perpetrating a fraud or other wrong on members of the public. In some jurisdictions,

---

15. See *infra* B.2. of this document.

16. In an LLC, “member” is the term used to denote an owner, in much the same way that “partner” refers to an owner in a partnership and “shareholder” means an equity participant in a corporation.

17. Some state statutes require any such agreement to be in a writing signed by the member in order to be enforced against such person.

18. See, *i.e.*, Memorandum Decision in *Bastain v. RJM Associates, LLC*, 29 Conn. L. Rptr. 646 (June 4, 2001)

fraud or similar misconduct must be proven in order to pierce the corporate veil and presumably the same standards will apply in such states to LLCs.<sup>19</sup>

With regard to the flexibility inherent in the LLC form of business, as mentioned earlier, the LLC statutes tend to include default rules on most of the issues that are likely to arise in the course of business operations. However, virtually all of these rules are subject to the contrary agreement of the members.

d. Contributions to an LLC

For example, consider the issue of contributions to an LLC. Most state statutes permit an LLC to accept contributions in the form of property, services rendered, or a promissory note or other obligation to contribute cash or property or to perform services in the future.<sup>20</sup> Even in jurisdictions where corporations are restricted from issuing stock in exchange for future services or a promise to pay in the future, most LLC statutes authorize contributions to take any form. Some statutes also require the members to agree to a value for all non-cash contributions and to keep a record of the value of each member's contributions. If, however, an LLC wanted to limit contributions, it could certainly do so. The requirement that the LLC keep a record of each member's contributions may or may not be subject to contrary agreement, depending on the state, but as a practical matter there is likely to be little reason to object to such a requirement.

e. Management of the LLC

More difficult is the issue of what an investor receives in return for a contribution to an LLC. By far the most common statutory model provides that the members of the LLC will have direct management power--this is a member-management model with members having power to bind the company to ordinary business contracts, akin to that found in general partners of a general partnerships.<sup>21</sup> Under this model, members start out with both actual authority to make management decisions and apparent authority or agency power to bind the LLC by acts that appear to be carrying on the ordinary business of the LLC.<sup>22</sup>

Some state statutes presume that each member will have a vote equal to that of every other member (the model adopted for general partnerships), but most statutes allocate voting power in accordance with the relative value of each member's contribution to the LLC (more akin to the limited

---

19. For a more detailed discussion of the issue of piercing the veil in the context of the LLC, see David L Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation For the Limited Liability Company?* 51 OKLA. L. REV. 427 (1998); Susan Muller Rogge, Note, *Hollowell v. Orleans Regional Hospital: Piercing the Corporate Veil of a Louisiana Limited Liability Company and Successor Liability*, 47 LOY. L. REV. 923 (2001); Shaun M. Klein, Comment, *Piercing the Veil of the Limited Liability Company, from Sure Bet to Long Shot: Gallinger v. North Star Hospital Mutual Assurance, Ltd.*, 22 J. CORP. L. 131 (1996).

20. U.L.L.C.A. § 401.

21. U.L.L.C.A. § 404. The uniform act makes this the default rule, as do most statutes. U.L.L.C.A. § 203(a)(6).

22. U.L.L.C.A. § 301(a)(1).

partnership model), unless the members have agreed otherwise.<sup>23</sup> All of the state statutes allow the members to change how voting power is allocated, and such provisions are frequently included in operating agreements. Particularly in jurisdictions which presume equal voting power, it is common to see attempts to bring voting rights more into line with the members' investments. A major drafting concern for this alternative is to choose a mechanism whereby the relative value of capital contributions can be determined readily and accurately. If an LLC is going to be operated informally, with different forms of consideration being accepted as capital contributions, this may be difficult to accomplish in a manner that is satisfactory to all concerned. In other cases, the members may desire to provide a mechanism which allows the LLC to charge varying amounts to members who buy into the enterprise at different stages. If voting power is presumed to be equal, or even if it is pro-rata based on the value of the members' contribution, it will take a specific agreement to accomplish this objective. One option is to provide in the operating agreement that the LLC will issue voting interests in exchange for defined contributions. Providing for such interests is particularly desirable if it is anticipated that these interests (sometimes called units or percentage of ownership) are transferrable. In any event, it is probably a good idea to carefully consider how voting power in an LLC is to be allocated.

It is not enough, of course, to merely decide on how voting power is allocated. A related issue involves the type of matters which require either super-majority or unanimous agreement. As with many issues, there is significant variation among state statutes about what issues are presumed to require more than majority approval, although it is accurate to say that state statutes often presume that it will take a unanimous vote to do things that would fall outside the ordinary way of doing business.<sup>24</sup> These might include a presumption that it will take unanimous agreement to amend the articles or the operating agreement of the LLC, to admit new or substitute members, to voluntarily dissolve the LLC, to merge or consolidate the LLC with another business entity, to sell all or substantially all of the LLC's assets, or to agree to continue the LLC despite what would ordinarily be an event of dissociation.

State statutes may also require unanimity to do things such as compromising an obligation by a member to make additional contributions, or settling disputes or agreeing to arbitration. After consulting the particular state statutes, it may be appropriate to make changes to the default rules concerning what types of actions would normally require unanimous approval.

Finally, most statutes are silent on the issue of formalities that may be imposed in connection with member-management.<sup>25</sup> Most state LLC statutes have omitted any presumptions or requirements with regard to issues like whether the LLC must hold annual or other regular meetings, who has the power to call special meetings, and such things as notice, quorum, and voting procedures. Most statutes do not even specifically presume that formal votes will be taken, so any desired formalities should be spelled out in the operating agreement for the LLC. If members want to guarantee that they are consulted in advance about certain issues, the requirement for meetings may be appropriate. Otherwise, the ability to operate a business without the relatively rigid procedures typically required of corporations is another benefit of the LLC form of business.

---

23. U.L.L.C.A. § 404(a)(1).

24. U.L.L.C.A. § 404(c).

25. The uniform act, for example, does not address this issue.

As an alternative to member-management, all state statutes provide that the members may elect a manager-management model akin to that of directors in a corporation. (In fact, a minority of jurisdictions presume that this is the management structure for any LLC formed under the statutes of that state.) Under this model, the members agree to delegate actual and apparent authority to managers, usually by including a provision to this effect in the articles. While most state statutes require that any election to choose manager-management must be included in the articles,<sup>26</sup> there is no requirement that the articles specify how managers are to be selected or replaced, or how they are to manage. Some of these issues are addressed by other statutory presumptions; some of them are not addressed at all in most state statutes.

Manager-management means that the managers will have both the actual power to manage and the apparent authority to bind the business by acts which appear to be carrying on the ordinary course of the LLC's business.<sup>27</sup> Members, as such, have neither actual nor apparent authority by virtue of their status as owners of the business.<sup>28</sup> In most states, managers are presumed to have equal voting power with every other manager.<sup>29</sup> Some statutes do not address this issue. Typically, the LLC statutes are silent as to most of the procedures and requirements that will have to be imposed if manager-management is selected. Most statutes neither impose default qualifications on who may be selected as manager, nor specify how managers are to be selected, how long they will serve, how they will be replaced, whether or how they can be removed, or any formalities with regard to voting, notice, meeting, quorum, or record-keeping. Generally, then, these are issues that probably should be addressed in the LLC's operating agreement. Particularly where the manager-management model is chosen, it will probably be desirable to impose some formalities with regard to decision-making and record-keeping in order to protect the interests of members who are not managers.

Even with manager-management, most state statutes retain some issues which are presumed to require approval of all or a majority of members.<sup>30</sup> These may include a decision to amend the articles or the operating agreement of the LLC, to admit new or substitute members, to voluntarily dissolve the LLC, to merge or consolidate the LLC with another business entity, to sell all or substantially all of the LLC's assets, or to agree to continue the LLC despite what would ordinarily be an event of dissociation. If the parties wish to reserve different decisions for the members, or wish to allocate the responsibility to decide on these kinds of issues to managers, they are generally free to do so in the LLC's operating agreement.

Despite the fact that most statutes speak only of member-management or manager-management as the primary management options, one of the hallmarks of the LLC is its extreme flexibility, and thus either of these models may be chosen with the operating agreement nonetheless delegating actual authority over some or even all decisions to others. This "hybrid" management can exist no matter what management structure is generally chosen. Thus, if the default rules call for member-management, and the members do not elect to change this in the articles, they may nonetheless choose to allocate some actual power to "managers" (however denominated) by

---

26. U.L.L.C.A. § 203(a)(6).

27. U.L.L.C.A. § 301(b)(1).

28. U.L.L.C.A. § 301(b)(1).

29. U.L.L.C.A. § 404(b)(1).

30. U.L.L.C.A. § 404(c).

inclusion of a provision to that effect in the operating agreement. Similarly, even if the articles purport to choose manager-management, the operating agreement may reserve some (or even all) actual authority to the members. In fact, there are virtually no limitations on how the parties might choose to allocate actual authority over decision making. However, the one thing which appears to be unavoidable under most state statutes is that under the member-management model members will have apparent authority to bind the LLC by acts that appear to be in the ordinary course of the LLC's business, and in the manager-management model managers will have such power.

f. Allocations of Profits and Losses, and Distributions

The other major considerations in making a contribution to an LLC are likely to be economic. From an individual member's standpoint, the economic claims of the member against the LLC may have paramount importance among all the issues with which the member will be concerned. Therefore, it is critical that economic claims, above all other matters, are clearly defined and understood. Most state statutes provide that members are presumed to share in income or losses in proportion to the value of their contributions to the enterprise, but a number of states presume that members will share equally, regardless of the relative value of contributions made to the LLC by the members.<sup>31</sup> The former rule appears to be more often the desired approach, and so it is very common in jurisdictions with a presumption of equal sharing in profits and losses to specify an agreed-upon allocation in the operating agreement.

Some important terminology with regard to a member's economic interest in an LLC bears noting. A domestic LLC (that is, an LLC formed under the laws of any American jurisdiction) will generally be taxed as a partnership.<sup>32</sup> This means that it is important to distinguish between allocations (or allocable shares) and distributions. Each year, the LLC will calculate its total income or loss.<sup>33</sup> It will then file an informational return that will show how the LLC's income or losses have been allocated among the members.<sup>34</sup> An allocation is the proportion of any item of income, gain, loss or deduction that is attributed to each member and has nothing to do with amounts that may actually be distributed or paid out. Thus, members in an LLC are likely to be very concerned with the allocation of profits, the allocation of losses (which can have significant tax benefits), and distributions.

Although the state default rules vary considerably, every state allows the members of the LLC to establish rules governing the allocation of profits and losses and rules applicable to the timing and amount of distributions. The default allocative and distributional rights of the members can be modified by appropriate provisions in the operating agreement. Allocations can be modified from the default rule to provide for per capita allocations, allocations based on relative value of contributions, allocations based on ownership interests or percentages, or otherwise. Moreover, state law does not

---

31. U.L.L.C.A. § 405.

32. Under the current federal tax regulations, this is the presumption for all LLCs having 2 or more members. Treas. Reg. §§ 301.7701-1 through -3, 26 C.F.R. 301. While a contrary election to be taxed as a corporation is possible, it is unlikely because partnership taxation avoids the double tax often associated with the corporate form. See part C.2 in the first document in this series. For a more detailed discussion of the tax issues applicable to LLCs, see *infra* part B.2 of this document.

33. I.R.C. § 703 requires the determination of an entity level "taxable income" by entities taxable as partnerships.

34. I.R.C. § 6031(a) requires the filing of an informational federal income tax return.

restrict the right of parties to allocate distinct items of gain and loss differently from the members' usual sharing ratios, although there are complicated and rigorous requirements imposed by the Internal Revenue Code and Treasury Regulations in order for such allocations to be respected for tax purposes.<sup>35</sup>

The parties are generally free to divide up the economic pie of the LLC in whatever manner they choose, and the flexibility afforded here (a characteristic carried over from the partnership) is one of the most attractive features of the LLC. However, any variation from the default rules should be clearly expressed in the operating agreement.

In addition, the members are likely to have a significant interest in the distributions from the LLC, both interim and liquidating. Distributions are generally based on cash flow rather than "profits" in either an economic or tax sense. Some operating agreements may contain an express formula for determining the amount of cash flow available for distribution. Other agreements will not contain specific formula provisions, assuming instead, as a general matter, that the LLC will not distribute what it does not have, and that those charged with managing the LLC should generally have discretion to declare distributions as they deem advisable.

Equally important to the determination of the amount available for distribution is when the distributions are to be made. Most state statutes say this will be as provided in the operating agreement or as the members in a member-managed or managers in a manager-managed LLC may decide.<sup>36</sup> In other words, there are no specific "default" provisions concerning the timing of interim distributions. The most informal way of handling the timing issue is to say nothing about it in the operating agreement. In that event, those in charge of management of the LLC, either members or managers, will decide when distributions will be made. On the other hand, the operating agreement may mandate that distributions be made when available cash flow permits. The availability of the cash flow could be assessed on whatever schedule the operating agreement provides, such as monthly, quarterly, etc.

The choice of whether to specify in the operating agreement when distributions are to be made will probably depend primarily on whether the LLC is member-managed or manager-managed. If the LLC is being managed by representatives of the members rather than the members themselves, the members may want the operating agreement to provide greater assurances that distributions will, in fact, be made with some regularity.

In the case of liquidating distributions by an LLC, most state statutes protect the rights of creditors by giving them a higher claim to the LLC assets than members have and generally providing that their claims will not be discharged before they are notified (actually or constructively) and given an opportunity to present their claims to the LLC.<sup>37</sup> In most cases, however, no express limitations are placed on interim (nonliquidating) distributions made by the LLC to its members.

---

35. The "special allocation" rules are the same ones which apply to all tax partnerships. This issue is discussed more fully in part C.2. of the first document in this series.

36. The uniform act requires unanimous approval for interim distributions in the absence of an agreement to the contrary. U.L.L.C.A. § 404(a)(6).

37. U.L.L.C.A. § 806(a).

It is not logical to assume, however, that LLCs are generally free to circumvent creditors' claims by simply distributing assets to its members in interim distributions that would leave the LLC unable to pay those creditors' claims on dissolution. Most states have adopted fraudulent conveyance laws that would operate to prevent any such strategy from being effective.<sup>38</sup> These acts give creditors a variety of remedies, ranging from the right to avoid any transfers in violation of the act, to injunctions against future transfers and the appointment of a receiver. These acts tend to treat as fraudulent any transfer made with "actual intent to hinder, delay, or defraud any creditor," or where the transfer is made "[w]ithout receiving a reasonably equivalent value in exchange," and the debtor's assets were unreasonably small.<sup>39</sup> The federal bankruptcy laws have similar provisions governing preferential transfers.<sup>40</sup> These standards provide limitations on interim distributions that should protect creditors' interests.

g. Transferability of Membership Interests

Turning now from the economic claims of a member against the LLC, there is another attribute of LLC membership interests that is likely to be of interest to persons considering this form of business: the extent to which such interests are transferable. In most states, the LLC statutory provisions on transferability of ownership interests have been modeled after the UPA, and provide that a transfer of an LLC membership interest operates only to transfer the economic rights, unless the remaining members unanimously agree to accept the transferee as a substitute member.<sup>41</sup> Of course, the members are free to agree otherwise. They may provide in advance that a membership interest is freely transferable and that any transferees will automatically be accepted as members of the LLC by the simple expedient of a provision to that effect in the operating agreement. Alternatively, they may provide that a limited class of persons (such as immediate family members or employees) will be entitled to full membership upon the acquisition of any membership interest.

Alternatively, the members could condition transferability by imposing transfer restrictions upon membership interests, which if met, would permit the transferee to become a member. Thus, the operating agreement could require a member to first offer any membership interests to existing members, or to the LLC itself, and only if these offers are rejected would a sale to a third person be recognized as entitling the transferee to membership status. The purchase rights accorded to the existing members could be structured as an option or as a right of first refusal. Such provisions are especially common in the corporate context, but where it is desirable to provide transferability of interests in order to entice additional investors into contributing to the capital funds of an LLC, such provisions may also be appropriate in this setting. Alternatively, the operating agreement might also be drafted to further restrict the transferability of membership interests, thereby limiting the ability of members to transfer even the economic rights of ownership.

---

38. See the General Notes to the Uniform Fraudulent Transfers Act, which indicate that versions of the statute have been adopted in Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Washington, West Virginia, and Wisconsin.

39. Unif. Fraud. Trans. Act. § 4.

40. 11 U.S.C.A. § 547.

41. U.L.L.C.A. §§ 502, 503(a).



#### h. Terminating Membership Status

The rights of a member to withdraw from an LLC may also be an issue in some cases. However, this is an issue which will vary considerably from jurisdiction to jurisdiction, as there is considerable disagreement among the state statutes as to the default rule.

The issue here is whether a member can voluntarily withdraw from an LLC. When most state LLC statutes were originally drafted, there were tax incentives in place to make the LLC look as much like a general partnership as possible. Thus, virtually all of the original LLC statutes provided that members in a LLC had the ability to withdraw at any time, even in contravention of a provision in the operating agreement prohibiting such withdrawal. This was in accord with the model followed by the UPA.

On the other hand, the tax justification for imposing the general partnership model on the LLC has since disappeared, and a growing number of states have recently modified their LLC statutes to change the default rule relative to rights of members to withdraw.<sup>42</sup> In such states, members generally have the ability to withdraw, but only if the operating agreement does not provide otherwise. If the operating agreement does restrict withdrawal rights, the member cannot simply quit.

These withdrawal rights create issues for both the member and the LLC. From the member's perspective, even though the LLC would not normally create personal liability for members, what if a non-managing member finds out that the LLC is operating in such a way that the veil of limited liability is likely to be pierced? In such a case, the member may very well wish to withdraw. Alternatively, the member may be concerned with avoiding tax liability. The LLC in question may be earning income, but failing to distribute it. Thus, the issue may be avoidance of tax liability. A provision restricting the member's ability to withdraw may be very undesirable in these situations.

From the point of view of the LLC, it may be extremely inconvenient to have a member withdraw at certain points in time. The LLC may wish to avoid having to calculate value of a member's interests as of certain points in time, or may fear that there will be significant but unprovable costs associated with withdrawal in violation of a contractual obligation to remain with the company that can best be resolved by a prohibition on voluntary withdrawal.

In any event, the right of members to withdraw, and the consequences of such withdrawal, are issues that probably should be specifically considered and agreed upon in advance. If members do have the ability to withdraw, notice requirements and any obligation on the part of the LLC to pay for the value of the withdrawing member's interest should probably be spelled out in the operating agreement.

---

42. Some states have chosen to eliminate the rights of members to withdraw voluntarily as the default rule. See, e.g., Okla. Legis. 145 § 6 (1997) (to be codified at Okla. St. tit. 18 § 2036); Or. St. § 63.205 (both eliminating power to withdraw unless provided in operating agreement). Other states have enacted legislation which provides that in the event of withdrawal, there is no "right" to be paid off, but instead the withdrawing member continues as an assignee of the interest. See, e.g., Colo. Rev. Stat. § 7-80-603; Mo. Stat. § 347.103; 1997 Neb. Laws L.B. 631 (to be codified at Neb. Stat. § 21-2619(3)); Gen. Stat. N.C. § 57C-3-02. Finally, some states have chosen to discourage voluntary withdrawal by eliminating a withdrawing member's right to distributions at the time of withdrawal. See Cal. Corp. Code § 17252(b); 31 Me Rev. Stat. § 672. See also Mich. Stat. § 450.4509 (eliminating the right to a distribution if the withdrawal is wrongful).

i. Dissolution, Winding Up and Termination

In most states, the rules governing dissolution, winding up and termination bear a substantial similarity to the rules applicable to other forms of enterprise. The events that trigger dissolution in the absence of an agreement are often very similar to the events that trigger dissolution of a general partnership, although a growing number of states seem to be reducing the number of events that automatically trigger dissolution. The statutes often list things like withdrawal, bankruptcy, incapacity or death of a member; agreement of all members; expiration of a stated term or completion of a specific undertaking; or anything specified in the operating agreement as constituting an event triggering dissolution. Some state statutes have been amended to narrow the list of things triggering dissolution, and every state statute allows the members to either subtract from or add to this list.

In addition, most LLC statutes have default rules governing the right of members to waive an event as a trigger for dissolution, and the members have the further right to provide in the operating agreement that any number of remaining members at the time of any such event will have the power to continue the business.

The LLC statutes also generally contain provisions for judicial dissolution, with considerable variation as to what constitutes sufficient grounds for a court to order dissolution of an LLC. Often this statute is very general, providing only that the court may order dissolution whenever it is not reasonably practicable to carry on the business of the LLC in conformity with the operating agreement or for any other equitable reason.

Once dissolution is triggered, most LLC statutes appear to follow the corporate model governing the winding up and termination of the business. There are provisions for the filing of articles of dissolution and the giving of notice to known and contingent creditors. There are provisions covering the distribution of assets and the possibility that creditors might later come after members for any amounts received as liquidating distributions.

**2. Tax Status**

a. In General

LLCs that have two or more members will be eligible entities under the current tax regulations. This means that under federal law they will be presumed to be taxed as partnerships, but any given LLC may elect to be taxed as a corporation.<sup>43</sup> Some state statutes impose a specific tax status on LLCs, regardless of how they might be classified for federal income tax purposes. LLCs having one member are authorized in some states. Under federal law, such LLCs will be taxed as sole proprietorships (that is, they will be disregarded for tax purposes) unless an election to be taxed as a corporation is filed.

Assuming an LLC is classified as a partnership, the LLC itself will not be subject to federal income tax, although an informational filing is required. For filing purposes, an LLC uses the same tax forms as a partnership: I.R.S. Form 1065 and Schedule K-1 for each member. The current versions of these forms contain questions designed to elicit whether the filing entity is a general partnership, a limited partnership, or a limited liability company. These questions do not affect the filer's tax liability but are simply a means of collecting statistical information.

---

43. Treas. Reg. §§ 301.7701-1 through -3, 26 C.F.R. 301.

Instead of taxation at the entity level, the members of the LLC, as tax partners, will be liable for income tax with respect to their distributive or allocable share of the LLC's items of income, gain, loss, deduction, and credit.<sup>44</sup> In an LLC, just as in a partnership, distributions of cash and property do not usually result in taxable gain to members, since members have already been taxed on their share of the LLC's income or have received their share of its losses.

As with partners, members in an LLC are generally free to agree among themselves how they will share profits and losses. This agreement will normally control the amount of each member's share of taxable income or loss, so long as these allocations satisfy the "substantial economic effect" test.<sup>45</sup> Assuming that test is met, the members may make special allocations of profits and losses in ratios different from their ordinary sharing ratios.

In general, an LLC is eligible to make the same elections that a partnership is eligible to make and is subject to the same rules that would apply to partnerships. However, certain tax provisions that apply to partnerships are based on the existence of a general partner or on the contrasting roles of general partners and limited partners.<sup>46</sup> Since an LLC has neither general nor limited partners, a question arises regarding the application of such provisions to LLCs. The bulk of the discussion that follows deals with some differences between the tax rules as they would apply to a traditional partnership and an LLC.

#### b. Basis Adjustments

One of the advantages of partnership taxation is the ability of tax partners to utilize losses to offset other income. One of the traditional limitations on a tax partner's right to utilize losses to offset income is that a tax partner can deduct his or her share of entity losses only to the extent of the tax partner's adjusted basis in its membership interest.<sup>47</sup> For this reason, the issue of whether a member is entitled to increase his or her basis as a result of the incurrence of indebtedness by the LLC is potentially quite significant.

Generally speaking, a member (as a tax partner) is only entitled to increase his or her basis in the amount of such member's "share" of the LLC's indebtedness. The regulations contain detailed rules describing the determination of the appropriate share of the debt for this purpose,<sup>48</sup> and the results will vary depending on whether the debt is considered to be recourse or nonrecourse debt. The regulations distinguish recourse from nonrecourse debt on the basis of liability of the members (or tax partners).<sup>49</sup> If no member bears the economic risk of loss, then the debt is nonrecourse debt. In

---

44. I.R.C. §§ 701, 702.

45. See I.R.C. § 704(b) and regulations promulgated thereunder. This topic is discussed in considerably more detail in part C.2. of the first article in this series.

46. For a more complete listing of partnership provisions of uncertain application to LLC members, see Steven G. Frost, *"Square Peg, Meet Round Hole": Classifying LLC Members as "General Partners" or "Limited Partners" for Federal Tax Purposes*, 73 TAXES 676 (1995).

47. I.R.C. § 704(d).

48. See Treas. Reg. §§ 1.704-2(b), 1.752-2.

49. See regulations promulgated pursuant to I.R.C. § 752.

an LLC, since no member has personal liability, presumably all debt would be nonrecourse under this standard, including debt that, from a commercial standpoint, would probably be viewed as recourse because the lenders have the right to look to the general assets of the enterprise to satisfy the debt. No rulings, however, have yet confirmed this analysis in the LLC context. An LLC may be advantageous if nonrecourse debt is desirable in a particular transaction, but the down-side is that such indebtedness is unlikely to increase the member's basis.)

c. The "At-Risk" Rules

The ability of individuals and certain closely held corporations to deduct losses of tax partnerships, and thus LLCs, is also limited by the "at-risk" rules.<sup>50</sup> In general, members may deduct losses only to the extent that they are "at risk" with respect to the entity. For an LLC, the question is whether a members' obligations other than capital contributions will be considered an amount at risk since, as described above, the debt of an LLC will normally be nonrecourse. Although the law is less than clear, it appears that a member will be at risk for the share of LLC debt that the member guarantees.<sup>51</sup>

d. Passive Losses

The passive loss rules prohibit certain taxpayers from using net losses from passive activities to offset other taxable income. A "passive activity" is defined as any activity in which the taxpayer does not "materially participate."<sup>52</sup> Taken together, the Internal Revenue Code and Treasury regulations set out a system of rules pursuant to which it is possible to determine when a partner is deemed to materially participate in the operation of a business. There are seven possible alternatives pursuant to which a general partner will be found to meet this test, but the rules applicable to limited partners are significantly narrow. The Internal Revenue Code presumes that limited partners do not materially participate<sup>53</sup> in a business and there are only three ways in which a limited partner can prove otherwise:

(a) The limited partner can work for the company for more than 500 hours in the year in question;

(b) The limited partner may have materially participated in five out of the ten preceding taxable years, or

(c) In the case of a personal service activity, the limited partner can have materially participated in any three preceding taxable years (whether or not consecutive).<sup>54</sup>

---

50. I.R.C. § 465.

51. Compare Prop. Treas. Reg. § 1.465-24(a)(2) with Prop. Treas. Reg. § 1.465-6. See also *Gefen v. Commissioner*, 87 T.C. 1471 (1986) (limited partner held at risk when guarantee ran directly to partnership's creditor); *Abramson v. Commissioner*, 86 T.C. 360 (1986) (limited partner who guarantees nonrecourse debt is at risk).

52. I.R.C. § 469(c).

53. I.R.C. § 469(h)(2)

54. Temp. Treas. Reg. § 1.469-5T(e)(2).

A "limited partnership interest" is defined as an interest with respect to which the liability of the holder is limited under state law to a determinable fixed amount.<sup>55</sup> It is as yet unclear whether LLC members are encompassed within this definition. If they are, then LLC members will be restricted to the three methods described above for limited partners to materially participate, rather than all seven methods available to general partners. The I.R.S. is studying the application of the material participation tests to LLC members. Until its position is clarified, however, LLC members should plan to meet the stricter tests for limited partners.

e. The "Tax Matters" Partner

The Internal Revenue Code provides a comprehensive system for determining, at the partnership level, the tax treatment of partnership tax items in unified administrative and judicial proceedings.<sup>56</sup> If the LLC is a tax partnership, the partnership audit provisions should apply in their entirety to the LLC. There is one complication with respect to the designation of a "Tax Matters Partner" (TMP), however. The Code<sup>57</sup> provides that the TMP is (a) the general partner designated as the TMP as provided in regulations or (b) if none, the general partner having the largest profits interest. If this rule cannot be applied, the statute provides that the TMP is to be selected by the Secretary of the Treasury.

Since an LLC has no general partner, it is uncertain whether the Secretary has the right to select the TMP. On December 23, 1996, a regulation was finalized regarding the designation or selection of a TMP for an LLC.<sup>58</sup> For purposes of applying this regulation to an LLC, only a member-manager is treated as a general partner and a member of an LLC who is not a member-manager is treated as a partner other than a general partner. In the regulation, a "member-manager" is defined as a member of an LLC who alone or together with others is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. The regulation provides, however, that if there are no elected or designated member-managers, each member will be treated as a member-manager. Thus, if this regulation is finalized, it will mean that if the LLC appoints a manager, that manager will be the only general partner and, thus, the only person eligible to be a TMP. If, on the other hand, no managers are appointed, all members are treated as managers and thus are eligible to be appointed as a TMP. Practitioners should be sure to have the members agree in writing regarding the designation of a TMP.

f. Self-Employment Taxes

As currently written, the Internal Revenue Code imposes a special tax on net earnings from self-employment.<sup>59</sup> This self-employment tax applies to the "net earnings from self-employment" derived by an individual, subject to certain exceptions. The Code defines "net earnings from

---

55. Temp. Treas. Reg. § 1.469-5T(e)(3).

56. I.R.C. §§ 6221 - 6231.

57. I.R.C. § 6231(a)(7).

58. Treas. Reg. § 301.6231(a)(7)-2.

59. I.R.C. § 1401.

self-employment" to include an individual's distributive share, whether or not distributed, of income or loss from any trade or business carried on by a partnership of which the individual is a partner, unless a specific exception applies.<sup>60</sup> The tax liability attaches to a partner's distributive or allocable share of trade or business income, which may be significantly different from (and greater than) the cash actually distributed to a partner. In other words, if a partner's share in the annual profits of the tax partnership amounts to \$100,000, that amount will be allocated to the partner for tax purposes. It does not matter whether any or all of that amount is actually distributed to the partner; the entire amount is taxable as income, and may also be considered self-employment income. The tax on self-employment income is meant to mirror both the employer's and employee's share of FICA, and is approximately 15½ per cent of a general partner's share of trade or business income.<sup>61</sup>

The reason that this is an issue for LLCs is that the tax regulations treat allocations to general partners differently from allocations to limited partners. Although the general rule is that partners are to be taxed on their allocable share of income, items of income or loss allocated to limited partners generally are not to be treated as net earnings from self-employment,<sup>62</sup> except for guaranteed payments as defined by the Code.<sup>63</sup> As a result, limited partners generally enjoy an exemption from the self-employment tax, while general partners do not. The question is how this rule applies to LLCs, which under state law have neither general nor limited partners but members instead.

The Code does not specifically address whether members of an LLC should be treated as limited partners, and arguments can be made on both sides of the issue depending on how the LLC is formed and operated. If the members of an LLC are actively involved in the management of the business, it would seem inappropriate to treat those members as limited partners.<sup>64</sup> On the other hand, if the members are in fact no more than passive investors, it would seem equally inappropriate to subject their distributive share to the self-employment tax except to the extent of any guaranteed payments.

On December 28, 1994, the Internal Revenue Service issued proposed regulations (the "1994 proposed regulations") which first addressed the issue of whether members of an LLC should be subject to self-employment taxes.<sup>65</sup> Pursuant to the 1994 proposed regulations, a member of an LLC was to be treated as a limited partner, and thus not subject to the self-employment tax, if certain conditions were met. First, the member could not be a manager, meaning not only that the member

---

60. I.R.C. § 1402(a).

61. The actual rate is based on two separate taxes, the old-age, survivors, and disability insurance (OASDI) tax of around 12½% and the Medicare tax of nearly 3%. As with FICA, the OASDI tax applies only to income below a specified level, which in 2001 was \$80,400. The Medicare tax does not have any cap.

62. I.R.C. § 1402(a)(13).

63. See I.R.C. § 707(c).

64. For example, the Service has ruled privately that members of an LLC who actively engage in the performance of professional services engaged in by the LLC must include their distributive share of the LLC's income and loss in their net earnings from self-employment. P.L.R. 9432018.

65. Prop. Treas. Regs. § 1.1402(a)-18.

could not be a designated manager, but also that the LLC could not have member-management.<sup>66</sup> Second, under those regulations, an LLC-member would be treated as a limited partner and thus exempt from the self-employment tax regulations only if the LLC in question could have been formed as a limited partnership rather than an LLC in the same jurisdiction and the member in question could have qualified as a limited partner in such a limited partnership.

Public comments on the regulations pointed out likely administrative and compliance problems, as well as the fact that these rules might result in disparate treatment of individuals based on form rather than substance.<sup>67</sup> As a result, on January 13, 1997, the Internal Revenue Service and Treasury Department withdrew the 1994 proposed regulations, and issued new proposed regulations (the "1997 proposed regulations").<sup>68</sup>

The 1997 proposed regulations would have adopted a substantially simplified approach to determining who would be a "limited partner" for purposes of the self-employment tax calculations required under the Code. Under these regulations, a member in an LLC classified as a partnership for federal tax purposes would be treated as a limited partner unless the member: (1) has personal liability<sup>69</sup> for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.<sup>70</sup> There were also built in exceptions in the case of members who held more than one class of interest in the tax partnership or members who received guaranteed payments for their services to the tax partnership.<sup>71</sup> In such cases, if all of the requirements of the particular

---

66. Prop. Reg. 1.1402(a)-18(c)(3) states, "[A] manager means a person who, alone or together with others, is vested with the continuing exclusive authority to make management decisions necessary to conduct the business for which the LLC was formed.... If there are no elected or designated managers of the LLC, each member will be treated as a manager for purposes of this section."

Thus, absent the formal designation or election of one or more managers for a given LLC, all of that entity's members will be deemed to be managers for purposes of the self-employment tax calculations, with the result that none will qualify for the limited-partner exception to the self-employment tax.

67. See Notice of Proposed Rulemaking, Definition of Limited Partner for Self-Employment Tax Purposes, 61 Fed. Reg. 1702 (Jan. 13, 1997).

68. *Id.*

69. Personal liability in this context is defined in § 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations.

70. Prop. Treas. Reg. § 1.1402(a)-2(h)(2).

71. Proposed Treas. Reg. § 1.1402(a)-2(h)(3). This provision reads as follows: An individual holding more than one class of interest in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest:

- (i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest;
- and,

exception were satisfied, it should have been possible for a member to avoid paying self-employment taxes on his or her entire distributive share. These same standards applied to all tax partnerships,<sup>72</sup> except service partnerships.<sup>73</sup> These regulations were intended to ensure that similarly situated individuals were treated similarly under the self-employment tax provisions and are likely to achieve that result.

Unfortunately, there was substantial political opposition to these proposed regulations, and they were never adopted. The Taxpayer Relief Act of 1997, enacted by Congress as Public Law 105-34, prohibited the I.R.S. from enacting these proposed regulations or issuing any further proposed or temporary regulations on the matter prior to July 1, 1998. The Congressional moratorium has now expired without Congress' taking any action to clarify the self-employment tax status of LLC members. With the I.R.S. also taking no further action to resolve the questions, practitioners lack clear guidance as to an LLC member's self-employment tax obligations. The 1997 proposed regulations do, however, remain the latest pronouncement on the subject from the I.R.S., and as such may offer some insights into how the service might decide to treat allocations to LLC members.

However, the law here is clearly uncertain, and there is no guarantee that the Internal Revenue Service will respect any decision to treat a member's share of LLC income as anything other than self-employment income, unless the membership of the LLC is set up so that all income funnels through another entity, such as an S corporation. This substantially complicates the structure required to be formed and maintained and may result in other, unintended tax or business consequences that are less desirable.

### **3. Comparing the LLC with Other Organizational Forms.**

From a tax standpoint, the LLC, in comparison with the corporation, is generally the entity of choice. This is so regardless of whether the corporation is taxed under subchapter C or subchapter S of the Internal Revenue Code. However, the lack of uniformity among the state LLC statutes may make the corporation more attractive for an enterprise doing business in multiple states.

An LLC offers significant advantages over an S corporation from a tax standpoint. First, there is no limit on the number of members of an LLC, although an LLC with more than 500 members is likely to be taxed as a corporation since it will be presumed to be publicly traded.<sup>74</sup> Therefore, if interests in the entity are expected to be very widely held, the LLC form (just like the

---

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

*Id.*

72. *Id.*

73. If substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner. Prop. Treas. Reg. § 1.1402(a)-2(h)(5).

74. I.R.C. § 7704.



partnership form) may be problematic. There is, however, no prohibition against LLCs having a large number of members.

Similarly, there is no restriction on the type or character of members of an LLC as there is for S corporation shareholders.<sup>75</sup> While S corporations may not have nonresident alien shareholders, nonresident aliens may own LLC interests. While S corporation shareholders are limited to individuals or certain types of trusts, LLC interests may be owned by individuals, corporations, partnerships, and pension plans. The relaxed ownership criteria of an LLC are one of the most important reasons for preferring LLCs over S corporations.

In addition, because LLCs are treated as partnerships for tax purposes, the members of an LLC enjoy a variety of tax advantages not available to S corporation shareholders.<sup>76</sup> One benefit is that no election need be filed in order for an LLC to receive the benefit of partnership tax status. In contrast, in order for a corporation to obtain S corporation treatment, it must file an election on or before the fifteenth day of the third month of its taxable year.<sup>77</sup>

Perhaps most importantly, LLCs, because they are taxed as partnerships, can use special allocations, pursuant to which, for example, taxable income and loss and distributions of cash or property may be allocated among the members in ratios different from the ratio of their respective capital contributions.<sup>78</sup> In contrast, if S corporations attempt to incorporate with provisions similar to special allocations, they would almost certainly violate the "one class of stock" rule applicable to S corporations.<sup>79</sup>

Finally, the S corporation tax rules are extraordinarily complex and contain many traps for the unwary, particularly with respect to the qualification tests. A form of doing business which does not require application of these rules, such as the LLC, may therefore be a more attractive option, particularly since the LLC offers the same essential features of limited liability and flow-through taxation.

When compared to a C corporation, the LLC is even more advantageous, because the LLC is eligible for partnership taxation with all that implies, in contrast to the double-taxation imposed on corporate earnings which are later distributed as dividends. The ability of members to share in losses and to easily avoid any entity-level tax is a very significant tax advantage of the LLC form.

A C corporation pays tax on its earnings at the corporate rate, and, upon distribution to the shareholders, the shareholders pay tax on the dividends at their individual rates. The combined burden of corporate level tax at the 1999 rate of 35 per cent and individual level tax at the rate of 39.6

---

75. I.R.C. § 1361.

76. For example, LLCs, because they are taxed as partnerships, can take advantage of the benefits afforded by a § 754 election. Under I.R.C. § 754, a member can step up its basis in its share of the LLC property to reflect that member's outside basis in the membership interest. No comparable election is available for S corporations.

77. I.R.C. § 1362.

78. I.R.C. § 704(b).

79. I.R.C. § 1361.

per cent was 60.74 per cent. There are obvious advantages to partnership tax treatment, pursuant to which only a single tax is paid at the member level.

From a nontax standpoint, a corporation (whether an S corporation or a C corporation) may have an advantage over an LLC with respect to the more settled nature of the law that governs it and the routine nature of its administration. An LLC, being a new form of doing business, raises issues regarding the application of laws and legal doctrines to it. For example, questions of the application of the concepts of fiduciary duties, corporate opportunity doctrine and its treatment under SEC, bankruptcy, and other federal laws may be uncertain.

On the other hand, the corporation has built-in formalities and a relatively rigid management structure. To the extent that the parties desire a less formal form of business, the LLC is likely to be comparatively advantageous. In fact, the lack of formalities and inherent flexibility of the form of business was one of the primary advantages touted by those responsible for the widespread enactment of LLC legislation.

The key difference between partnerships and LLCs is that an LLC offers limited liability to all of its members, whereas in traditional partnerships, even a limited partnership, at least one partner (the general partner) has liability exposure. In contrast, no member of an LLC has personal liability for the debts of the LLC, barring guarantees or other special arrangements between members and creditors. Although this problem can be handled in a partnership by using a corporate general partner, if the corporate general partner is a C corporation, tax will be imposed on the profits of the partnership at the corporate level to the extent they are allocated to the corporation. Even if the corporate general partner is an S corporation, so that no entity level tax is imposed on the corporation's share of the profits, the use of such a structure raises issues not present for an LLC.<sup>80</sup> This particular advantage under state law applies only to traditional partnerships, and not necessarily to LLPs or LLLPs.

In addition, general partners in a partnership, even limited partnerships, LLPs, and LLLPs, always have certain rights which may not be ideal. First, such partners always have agency power or apparent authority to bind the business by acts which appear to be carrying on the usual business of the partnership. In certain cases, it may be desirable to limit this authority, an option not available under partnership law but possible if an LLC utilizes managers to manage the business. Second, general partners always have the power to withdraw from the business, even if such withdrawal is in violation of the partnership agreement. Such withdrawal triggers technical dissolution and may make it more likely that the business will have to be wound up unless a sufficient number of remaining partners specifically elect to continue. This may be a problem for some businesses, and while partnership law does not permit a partnership agreement to effectively prohibit withdrawal, LLC statutes do provide for this option. These advantages apply when LLCs are compared with general partnerships, limited partnerships, LLPs and LLLPs.

One advantage of LLCs over limited partnerships and LLLPs is that LLC members can participate in management of the LLC without risking their limited liability status. In contrast, if a limited partner participates in the control of the partnership, he may lose his status as a limited partner. Significantly, this ability to manage without losing liability protection may mean that LLC members can

---

80. For example, in Rev. Proc. 89-12, 1989-1 Cum.Bull. 798, the I.R.S. has taken the position that a corporate general partner in a limited partnership must have an interest of at least one percent in all partnership tax items and contribute at least one percent of the capital in order for the partnership to be classified as a partnership. Similarly, issues are raised regarding the net worth or capitalization of a corporate general partner. These issues are generally not present for an LLC.

participate in management for purposes of the "material participation" tests of the passive loss rules without losing their liability protection. Material participation by a member may cause what would have otherwise been treated as passive income or loss to become active income or loss and thereby be available to offset against other active income or loss.

Finally, with regard to LLPs and LLLPs, there are a couple of reasons why LLCs may be preferable. First, LLPs and LLLPs may not offer general partners complete protection against entity-level debts. Statutes in a number of states still provide partners in such enterprises only protection against liabilities arising out of the misconduct of others.<sup>81</sup> The partners in such jurisdictions would normally retain personal liability for ordinary business debts. Second, there is much more inconsistency between various states with regard to LLPs and LLLPs. Not only do the states differ in regard to the type of liability to which partners may be exposed, some states do not even offer limited partnerships the possibility of registering as LLLPs. Thus, the risks of doing business in multiple jurisdictions are heightened. In addition, LLP and LLLP law appears to be more likely to change in the next few years as more states adopt the new revisions to the Uniform Partnership Act. Thus, there is greater uncertainty associated with this form of business, potentially making the LLC a more stable option.

This is not to say that the LLC is right for every business. Because of the extreme flexibility of this form of business, it will often cost more in terms of legal fees to set up the business in the appropriate manner. In addition, it is still less familiar than the corporate form for many legal advisors and tax practitioners, and this may also have an impact on fees. Some accountants apparently advise clients that the S corporation is generally cheaper to run than an LLC, at least from a tax and accounting standpoint. Finally, there are tax rules which may make the LLC less desirable in certain instances. Foremost among these are the rules applicable to self-employment taxes, although there are also other considerations which may be important in any given situation. For these reasons, it is always important to seek professional advice about the optimal choice of business entity in any given situation. The materials presented here should help the reader understand the basic issues and range of possibilities and make preparing for any such consultation easier.

## **C. Corporation**

### **1. Business Law Status**

#### **a. Traditional Corporation**

The corporation is probably the form of business entity which comes most readily to mind for most people.<sup>82</sup> It is formed by filing articles of incorporation (which may also be called the corporate

---

81. For a more detailed discussion of the liability of general partners in an LLP see part E.1 of the first article in this series. For a similar discussion applicable to LLLPs, see part F.1. of the first article in this series.

82. Although the corporation is also a creature of statute, every state has had a corporate statute for many decades. There is also a great deal of similarity between state corporate statutes. Rather than citing to multiple state statutes, these materials will cite to the current Model Business Corporation Act, a model statute promulgated by the NCCUSL. This statute has been extremely influential, and versions of the model act or its predecessors, have been adopted in many states. Nonetheless, there is still some variation from state to state, particularly with regard to details. Therefore, when a particular issue comes up in regards to the

charter) with the appropriate state officials. A corporation may also have written bylaws that will govern how the corporation is run on a day-to-day basis.

The equity owners of a corporation are called shareholders who, in their capacity as shareholders, have only very basic voting rights. They can elect the managers of the corporation (called directors); they are entitled to vote on most decisions that would require an amendment to the articles of incorporation, and they must approve certain fundamental transactions involving a change in structure of the corporation such as dissolution, mergers, consolidations, or mandatory share exchanges. Generally speaking, any legal person (including individuals, associations of persons and legal entities like LLCs) can be a corporate shareholder. In most states, investment in a corporation can be in the form of property, cash or services. However, a number of states do exclude promises to provide property or perform services in the future from the list of permissible contributions. In addition, there may be tax consequences for contributing services and certain forms of property to a corporation.

In the traditional corporation, day-to-day management decisions are vested with a board of directors, which generally requires the scheduling of meetings, the taking of formal votes on corporate resolutions, and the keeping of minutes reflecting corporate decisions. Because this level of complexity and formality is not particularly desirable or necessary in many small corporations, some state statutes allow smaller corporations to elect to have shareholders retain management authority by including a provision to that effect in the corporation's articles of incorporation. In the case of a small corporation with such an election, the shareholders could have direct management authority. Not all state statutes would permit or recognize such an election, however.

The right to share in the corporation's net profits depends on the stock held by each shareholder. Every holder of the same class of stock is entitled to a pro rata proportion of any distribution to the holders of that class of stock, although different classes of stock can have different priorities and claims to distributions. For the most part, the actual distributions (typically in the form of dividends) depend on the board of directors, who generally have very broad discretion in declaring dividends. Dividends are ordinary (taxable) income to shareholders.

Shareholders are not liable for losses of the corporation, and therefore are not entitled to report any loss on their personal taxes as a result of losses at the corporate level.

Absent agreement to the contrary, a shareholder may sell or otherwise convey shares at any time to any other legal person. The buyer or transferee becomes a shareholder, with all the rights such a position entails. While a shareholder who has control over the corporation cannot knowingly sell the control shares to someone who intends to come in and "loot" the corporation, there are very few limits on a shareholder's right and power to transfer shares.

The primary advantage to a corporation, aside from the fact that it is likely to be the entity with which practitioners and many business people have the greatest degree of familiarity and for which there are probably the greatest number of planning aids such as form books and treatises, is that all shareholders have limited liability for corporate debts. In other words, a shareholder stands to lose his or her investment in the corporation if the corporation acquires debts greater than its assets, but absent highly unusual circumstances, will not be compelled to pay additional sums to make good on those debts. Obviously, if the shareholder has signed a personal guarantee the shareholder will have

---

corporate law of a particular jurisdiction, the statutes of that jurisdiction should always be consulted as a starting point.

personal liability, and equally obviously, if the shareholder has no significant personal assets, the risk that those assets might be subject to entity-level debt is not particularly significant. However, for many business owners, protection against personal liability for entity level debt is a significant advantage.

b. Statutory Close Corporation

In recent years, a few states have adopted special statutes designed to govern closely held corporations that make a special election to be covered by these statutes rather than the general corporation statutes of the state. For the most part, the benefits of electing to be treated as a statutory close corporation are that the formalities required for management of a traditional corporation, such as the election and operation of a board of directors, are dispensed with.

There are actually three patterns which have developed in state laws relating to closely held corporations. Some states have adopted a unified strategy, where the same corporate laws are applicable to both large and small corporations. Under this approach, there are no special statutory provisions applicable to closely held corporations. The same rules and requirements apply to both small, closely held corporations, and large, publicly traded companies organized in such jurisdictions.

The second possible statutory approach is for a state to adopt an entirely separate set of statutes applicable to closely held corporations, or at least applicable to closely held corporations that elect to be treated as statutory close corporations. There is a model close corporation statute, but it has been adopted by very few states, and there is a great deal of variation between even those states that have a close corporation act.

The third approach is a combination of the first two. In states adopting this approach, most of the general corporation laws are applicable to all corporations, regardless of whether they are closely held or publicly traded. However, in such jurisdictions, there are also a few statutory provisions which apply specifically and exclusively to closely held corporations. In many cases, a closely held corporation is required to make a special election to be subject to these special rules. For example, in some states, corporations whose shares are not publicly traded are specifically authorized to adopt shareholder agreements which leave management power in shareholders' hands.<sup>83</sup> Such agreements would be void as against public policy in publicly held corporations, or even in closely held corporations absent such statutory authorization.

Shareholders of closely-held corporations, ranging from family businesses to joint ventures owned by large public corporations, frequently enter into agreements that govern the operation of the enterprise. In the past, various types of shareholder agreements were invalidated by courts for a variety of reasons, including so-called "sterilization" of the board of directors and failure to follow the statutory norms of the applicable corporation act.<sup>84</sup> The more modern decisions reflect a greater willingness to uphold shareholder agreements.<sup>85</sup>

---

83. For example, the current version of the Model Business Corporation Act, as promulgated by N.C.C.U.S.L., contains such a provision. M.B.C.A. § 7.32.

84. See, e.g., *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 77 N.E.2d 633 (1948).

85. See, e.g., *Galler v. Galler*, 32 Ill.2d 16, 203 N.E.2d 577 (1964).

Notwithstanding the increasing prevalence of close corporation provisions, very few corporations actually register as close corporations or take advantage of statutory provisions authorizing smaller corporations to dispense with or limit the authority of the board of directors. There are a number of reasons that make such reluctance rational. First, there is very little case law dealing with close corporations, and no lawyer wants his or her client to be the “guinea pig” on which the law is tested. For example, if a corporation chose to dispense with a board of directors, instead relying on direct management by the shareholders, would this increase the chances of the shareholders’ being held personally liable for corporate debts? Would the courts be more likely to pierce the corporate veil? Would dissenting shareholders be able to sue for simple mistakes in judgement? We simply do not know the answer to these questions because there are no cases dealing with these issues.

Moreover, it is not just the courts that are unfamiliar with these “close corporations.” Any time a corporation tries to open an account or borrow money from a bank, the bank is almost certain to produce standard forms which reflect directors’ resolutions and authorizations. Few banking officials are ready to deal with “corporations” that do not have directors or adopt formal resolutions.

In addition, there is so much variation from state to state in terms of what is permissible for a close corporation, that whenever the corporation is likely to do business across state lines, choice of law problems are likely to arise.

In the final analysis, to date few corporations have chosen to travel down this road. The bulk of the materials which follow, therefore, deal with the rules applicable to traditional corporations, both closely held and publicly traded. In the agricultural sector, most of such corporations would be closely held, although this is certainly not universally true.

#### c. Formation

The corporation is a creature of statute. Normally, the statutory requirements must be complied with in order for a corporation to come into existence, and in most states the corporation comes into existence when the articles are filed by the Secretary of State or other appropriate state official.<sup>86</sup> The articles of incorporation, sometimes called the corporate charter, contain very basic information about the corporation and are not intended to govern the day-to-day operation of the business.<sup>87</sup> The articles contain information such as the name of the company, often the address of the principal office in the state, a registered office and agent for service of process, detailed information about the stock which the corporation is authorized to issue, information about the incorporators, and possibly the purposes for which the corporation is to be formed. The articles may, but generally are not required to, include the names of the initial directors of the corporation.

Once the articles are filed, the organizers will typically meet to select the initial directors unless they were named in the articles. Once the directors have been named, the organizers are out of the picture.<sup>88</sup> The initial directors authorize the enactment of bylaws that will govern the day-to-day operations of the corporation. They will also authorize the issuance of shares and take whatever actions are necessary to get the corporation started.

---

86. *Accord* M.B.C.A. §§ 1.23 & 2.03(a).

87. M.B.C.A. § 2.02.

88. M.B.C.A. § 2.05(a)(1).

#### d. Contributions

It is very common for persons interested in forming a corporation to obtain commitments from potential investors when the corporation is formed. In order to avoid any question about the legality of this type of subscription arrangement, many corporate statutes specifically validate subscription agreements.<sup>89</sup>

In addition, the corporate statutes commonly address such issues as the process that should be undertaken in connection with the issuance of shares, the types of consideration that can legally be received by the corporation, and any minimum price that must be paid.<sup>90</sup> Most modern statutes allow shares to be issued in exchange for cash, property, services, services to be performed or a promise to pay money in the future. However, a few states still continue the rule which was more prevalent in earlier times that shares may not be issued for future consideration. Most states that retain this rule do so because of state constitutional provisions that are difficult to modify rather than any policy reasons for restricting the type of consideration that can be used.

With regard to the minimum consideration to be received, the law is generally that shares may be issued for any consideration determined by the directors to be adequate, provided that such amount may typically not be less than the par value of the shares as specified in the corporate articles.<sup>91</sup> "Par value" does not mean economic value; it is merely a floor below which a corporation may not issue its shares. Most states authorize no-par stock, but there may be adverse consequences associated with this, including the imposition of higher-than-necessary franchise taxes. However, a relatively low par value (\$.10 or even a fraction of a cent) is not at all uncommon.

With regard to establishing the value of non-cash property to be contributed in exchange for stock, most states provide that the determination of the directors will be conclusive, absent fraud or collusion.<sup>92</sup> Thus, it is always wise for the directors to adopt resolutions authorizing the issuance in exchange for specified consideration, which the directors should find to be of either a specific value or value at least equal to the par value of the shares.

Finally, there is no requirement that all shares must be issued for the same consideration or even consideration having the same value as that accepted in exchange for other shares. All of such decisions are within the sound discretion of the directors.

#### e. The Limits on Shareholder Liability

It is easy to state the rule that shareholders of a corporation have limited liability.<sup>93</sup> However, there are some important caveats and limitations that need to be understood, because this limitation on personal liability is not absolute. First, a shareholder is liable for the agreed-upon value of his or her

---

89. M.B.C.A. § 6.20.

90. M.B.C.A. § 6.21(b) & (c).

91. M.B.C.A. § 6.21(c).

92. M.B.C.A. § 6.21(c).

93. M.B.C.A. § 6.22.

contributions.<sup>94</sup> If the contribution has not been fully paid in, the corporation or a receiver appointed to run the corporation may recover such amounts if they have not been paid to the company. In addition, the agreed-upon contribution must be equal in value to the par value of the shares to be issued in exchange therefor. If it does not, the shareholder faces potential liability for “watered stock.” Similarly, under the law of some states, there are restrictions on the type of consideration that may legally be paid, and failure to comply with these restrictions may result in excess personal liability. Finally, even if the contribution has been fully paid in, the shareholder stands to lose the value of such contribution in the event that the business fails. Generally speaking, a shareholder will only recover such value if all corporate creditors are paid in full.

In addition to liability for one’s contributions, a shareholder will also be liable for anything for which he or she agrees to be personally liable. Thus, if the shareholder executes a personal guarantee of a corporate loan, the guarantor’s status as shareholder will not prevent the creditor from recovering against the shareholder/guarantor.

Similarly, a shareholder retains personal liability for the consequences of his own tortious acts. This should not be surprising, since this rule applies regardless of the type of entity with which an owner is associated.

In addition, a shareholder may wind up with personal liability in the event that a court elects to “pierce the corporate veil” or, in other words, to disregard the existence of the corporation in order to impose such liability. Speaking in general terms, courts in every jurisdiction agree that they should pierce the corporate veil if there is sufficient proof that the corporation has been used in the furtherance of crime, to facilitate fraud, or to justify a similar wrong. Additionally, courts may pierce the veil when shareholder(s) have themselves failed to recognize the separate existence of the corporation and, instead, have relied upon it solely to insulate themselves from personal liability that ought to exist.

Some courts specifically require proof of fraud, inequity or wrongdoing in addition to the shareholder’s failure to respect the independent existence of the corporation. In any of these cases, once the corporate veil is pierced, the corporation is no longer viewed as a legal entity. Instead, the corporation is viewed as an association of persons, exposing the personal assets of the stockholders, and often the personnel connected with the wrongful activity such as corporate directors, to claims by creditors seeking compensation.

When deciding whether to pierce the corporate veil and subject the corporate insiders to personal liability, all courts look at the question of whether the shareholder(s) have properly respected the corporation’s legal existence.<sup>95</sup> Sometimes, this is spoken of in terms of whether the corporation

---

94. M.B.C.A. § 6.22(a).

95. In figuring out what the first part of the analysis requires, the relatively recent case of *National Soffit & Escutcheons Inc. v. Superior Systems, Inc.*, 98 F.3d 262, 265 (7th Cir. 1996), provides a good example of many of the relevant considerations. In this case, the Seventh Circuit concluded that a plaintiff must demonstrate (1) that the corporate form was “ignored, controlled or manipulated, and that it was merely the instrumentality of another, and (2) that the misuse of the corporate form would constitute a fraud or promote injustice.” In order to support such conclusions, the court established eight factors to consider when determining whether to employ its equitable power to pierce the corporate veil. These factors include (1) the undercapitalization of the corporation (2) the absence of corporate records; (3) the fraudulent representation by the corporation’s shareholders or directors; (4) the use of the corporation to promote fraud, injustice, or illegal



can properly be viewed as the “alter ego,” or “mere instrumentality” of the shareholders. In other cases, courts address whether the unity of interest and ownership are strong enough to make the corporate identity indiscernible from that of the individual. Sometimes, courts ask whether the corporation is a mere shell or dummy. In some jurisdictions, after this first part of the test has been employed, the courts will also consider whether an inequity would result if the bad acts are treated as those of the corporation alone. Some states require even greater proof of fraud or other wrongdoing.

Finally, there are other circumstances in which a shareholder may be liable for at least some amounts; for example, a shareholder may have to repay illegal distributions or payments which violate either the bankruptcy preference rules or the state’s fraudulent conveyances act. Similarly, a shareholder may find that his or her claims against his or her corporation are subordinated to the claims of other creditors under the theory of equitable subordination. However, these are not rules which impose substantive liability for unlimited amounts, as can be the case when the corporate veil is pierced.

f. Management of a Corporation

Corporate statutes are pretty clear on the subject of management: under normal circumstances, all management authority is to be exercised by or under the authority of the board of directors.<sup>96</sup> The formalities associated with actions by the board of directors are one of the indicia of separate existence of the corporation and thus deserve special attention.

Generally speaking, directors are required to hold meetings at least annually or more often as the bylaws may require.<sup>97</sup> Moreover, all state statutes provide for special meetings.<sup>98</sup> Generally speaking, there are notice, quorum, and record-keeping requirements for directors that should be carefully respected.<sup>99</sup> Many of these formalities will be foreign to individuals in a business. However, the formalities need to be observed in order to minimize the risk that the corporate veil will be disregarded. Because it is not reasonable to expect individuals who are not familiar with business operations to remember all of the details of these formalities, many attorneys list the most important formalities (meeting times, quorum, voting, and notice requirements, etc.) in the company’s bylaws. This has the virtue of creating a document which explains how the corporate directors should proceed.

For those who are exploring the possibility of becoming minority participants in a corporate venture, it is important to emphasize how complete is the directors’ authority. In essence, the

---

activities; (5) the payment by the corporation of individual obligations; (6) the commingling of assets or affairs; (7) the failure to observe required formalities; and (8) the other shareholder acts or conduct. In *National Soffit*, the shareholder was actually another corporation. However, the basic rule is the same: such liability should exist if the subsidiary acted as a mere instrumentality of its parent.

96. M.B.C.A. § 8.01(b).

97. M.B.C.A. § 8.20.

98. M.B.C.A. § 8.20.

99. M.B.C.A. §§ 8.22 & 8.24.

directors have full authority over the day-to-day operations of the corporation and need not consult with or accept advice from others.<sup>100</sup>

With regard to the control that the shareholders do have, they generally have the power to nominate and elect directors, to remove them and to select their replacements. Directors may typically be elected with a plurality of the votes, and in a minority of jurisdictions shareholders are presumed to have cumulative voting privileges.<sup>101</sup> Even in jurisdictions where cumulative voting is not presumed, the articles may provide that shareholders will have this right.

g. The Rights of a Shareholder to Recognize a Return on the Investment

Typically, a shareholder who invests in a corporation expects a return on that investment in one of two forms: dividends or appreciation in the value of shares. However, closely held corporations are often structured so as to pay out significant amounts of earnings in other ways.

A primary motivation for avoiding dividends is that dividends are subject to double taxation: net corporate earnings are taxed once, at the corporate level, and then again, as ordinary income, when paid to shareholders.<sup>102</sup> In contrast, if the investor also works as an employee and receives a return in the form of wages, to the extent that the wages are a reasonable business expense of the corporation, those amounts are deductible by the corporation.<sup>103</sup> This means that, while the shareholder will still have to treat the payment as income and pay individual income taxes on it, the corporation will not have to pay corporate income tax on money paid out in the form of wages. Similarly, if the investor lends funds to the business and receives interest, the interest is a deductible business expense.<sup>104</sup> Rental payments may receive similar treatment, so long as the rental amounts are not disguised payments toward eventual purchase of the underlying property.<sup>105</sup>

The right of the corporation to deduct wages and interest is not unlimited. Only reasonable business expenses may be deducted by the corporation. This means that there may be disagreements between taxpayers and the I.R.S. as to what constitutes a reasonable business expense.

---

100. *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85 (1880), exemplifies these rules. In that case, the court found that the directors were not liable for failing to heed the advice of an expert recommended and appointed by the shareholders in connection with the winding up of the business, even though failure to pay attention to those recommendations cost the corporation thousands of dollars.

101. Cumulative voting means that, rather than electing directors one at a time, all directors are elected in a single vote. Each shareholder is allowed to cast votes equal to the number of shares owned times the number of directors to be elected. A shareholder may cumulate those votes and cast them for a single individual, or break up the votes between nominees in any manner the shareholder desires. This cumulative voting has the effect of concentrating the voting power of the minority shareholders, provided that minority shareholders do indeed cumulate their votes for a single candidate.

102. I.R.C. §§ 62, 63 (defining gross and taxable income).

103. This would be allowed as an ordinary business expense. See I.R.C. § 162(a). However, the wages would be subject to employment taxes, which are generally not applied to dividends.

104. See I.R.C. § 163. Repayment of principal would not be income to the lender.

105. Rev. Rul. 55-540.

Notwithstanding these alternatives to dividends, the usual way for shareholders to realize income through their investment is in the form of dividends. Corporate statutes generally authorize directors to pay dividends, in their discretion, so long as the payment is consistent with the corporate bylaws and does not render the corporation insolvent.<sup>106</sup> In fact, every state corporate statute references in some way the prohibition of dividends that would render the corporation unable to pay debts as they come due, or which would leave the corporation with debts that exceed assets or that would impair the corporation's capital. The precise nature of the limitation varies from state to state, but the general import of the rule is clear: dividends are to be paid if and when declared by the directors and only so long as they will not render the corporation insolvent.

Shareholders may also benefit from appreciation in the value of their shares. This is not a taxable event unless and until the shares are liquidated, either as part of a repurchase from the corporation or as part of a sales transaction. Generally speaking, shareholders are free to sell their shares to whomever they wish and are entitled to retain whatever price they receive. The limitations on this are that shareholders may not sell their shares to a third party who is known or should be known as someone who will loot the corporation; they may not accept a premium for the sale of directors' positions; and they may not sell in contravention of a reasonable restriction on transferability to which they have agreed or of which they had notice when they acquired their shares. Share transfer restrictions are dealt with in the next section of this article.

#### h. Transferability of Shares

Corporations traditionally possess the attribute of free transferability of interests. In other words, a shareholder's interest in the corporation (typically in the form of shares) can usually be sold to any other person, on any terms that the shareholder desires, unless the shareholder has voluntarily agreed to restrict these rights. Moreover, a transferee becomes a full shareholder with all the rights of the transferor. No consent by any other party is normally required to make this transfer complete. Contrast this with the partnership form of business, where a partner is normally entitled to sell only his or her right to profits, and a transferee acquires only limited rights under the default rules. Under this model, it takes affirmative agreement (either in advance or at the time of the transfer) in order to achieve transferability of an equity interest in the business.

However, in many close corporations, free transferability may not be completely desirable. There are any number of reasons why a corporation or its founders may want to limit the rights of shareholders to freely transfer their shares. For example, a corporation may be concerned that such sales might violate the federal or state securities laws and compromise the corporation's own sales of its shares. Alternatively, a sale of shares to certain prohibited shareholders or to too many shareholders may deny a corporation its S status under subchapter S of the Internal Revenue Code. Even if the sale does not involve tax or securities law problems, the promoters or primary shareholders may worry about control getting away from those who have an immediate connection with the business. They may want to limit share ownership to employees of the company or to prohibit the sale to those with a significant ownership interest in or management responsibilities to competing enterprises.

For these reasons, it is common to see close corporations whose shareholders have entered into a shareholder agreement that restricts the free transferability of the shares. Generally speaking,

---

106. M.B.C.A. § 6.40(a) & (c).

such restrictions are valid if they are reasonable and comply with other statutory provisions such as required notice.<sup>107</sup>

i. Termination of the Corporation

The process of terminating a corporation is spelled out in some detail in the corporate statutes. Unlike the situation with the partnership and LLC, most of these rules are mandatory and cannot be circumvented by agreement of the parties. However, the death, purported withdrawal or resignation, incapacity, etc. of a shareholder will not affect the viability of the corporation as an independent entity, so there is also less reason to try and circumvent the usual process of dissolution.

One point about terminology is worth emphasizing: dissolution of the corporation does NOT mean the withdrawal of shareholders or directors from the enterprise. It is just the first step in the winding up and termination process. Even after a corporation is dissolved, it continues in existence for the purpose of conducting the winding up.

The usual process requires the corporate directors to recommend dissolution to the shareholders.<sup>108</sup> This must then be approved by the appropriate shareholder vote; usually a simple majority vote will suffice.<sup>109</sup> Following this vote, the corporation is entitled to file articles of dissolution, give notice to known claimants and publish notice to unknown or contingent creditors.<sup>110</sup> The business continues until operations can be wound up, assets liquidated, and all debts paid off.

Although there is a five-year statute of limitations for contingent claims in most state corporate statutes,<sup>111</sup> this does not mean that the corporation must continue the winding up process for this entire period of time. Rather, the corporation typically distributes to the shareholders whatever is left after paying all creditors. If a subsequent claim is made, and it succeeds, shareholders who have received a liquidating distribution may be compelled to turn it over to the creditor, but they cannot be compelled to pay more than they received.<sup>112</sup> If the normal process is not possible, as for example would be the case where a majority of the directors refuse to refer the matter to a shareholder vote, or a majority of the shareholders oppose dissolution, the statutes also provide for judicial intervention.<sup>113</sup>

Most state statutes allow a shareholder to petition for judicial dissolution upon a showing of one or more of the following:

- (1) The directors or shareholders are deadlocked, and irreparable injury is occurring or is likely to occur;

---

107. M.B.C.A. § 6.27.

108. M.B.C.A. § 14.02(a).

109. M.B.C.A. § 14.02(b)(2) & (e).

110. M.B.C.A. §§ 14.03, 14.06, 14.07.

111. M.B.C.A. § 1407(c).

112. M.B.C.A. § 14.07(d)(2).

113. M.B.C.A. §§ 14.30 - 14.34.

(2) Those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

(3) The shareholders are deadlocked in voting power and have failed, for a specified period, to elect directors; or

(4) Corporate assets are being misapplied or wasted.<sup>114</sup>

In addition, creditors may obtain relief if it can be shown that they have a judgment or the corporation has confessed that the creditors' claims are owing, and the corporation is insolvent.<sup>115</sup>

Even where these grounds can be proven, the courts retain equitable power to decide whether or not to grant judicial dissolution. Courts appear rather reluctant to order a solvent corporation to be dissolved, imposing in the alternative numerous creative remedies designed to protect the injured shareholder. With regard to the proper interpretation of these provisions, "oppressive conduct" has generally been held to mean any intentional thwarting of the minority's reasonable expectations. "Deadlock" requires an absolute inability to agree and therefore an inability to make business decisions.

If judicial dissolution is ordered, the court may also order the dissolution to be conducted under the direction of the court or an appointed receiver. The same procedures that apply to traditional dissolution are then followed.

## **2. Tax Status**

### **a. S Corporation**

An S corporation is simply an otherwise ordinary corporation which is eligible for and has elected to be taxed under subchapter S of the Internal Revenue Code. For state law purposes, it is formed like any other corporation, and the provisions of the general business corporation statutes will apply. In cases where the corporation meets the requirements of any applicable close corporation statutes or provisions, those statutes may govern the corporation. The only differences between S and other corporations come from rules and restrictions imposed by subchapter S of the Internal Revenue Code.

The benefit of electing subchapter S status is that an S corporation is a flow-through entity. In other words, there is no entity level tax. Items of income and loss flow through to the shareholders and are taxed only at the shareholder level.

The disadvantage of an S corporation is that they are considerably less flexible than C corporations. An S corporation can have no more than 75 shareholders (until 1996, that limit was 35); the moment its shares are owned by more than 75 investors, the corporation loses its status as an S corporation and becomes taxable as a C corporation. Moreover, with certain limited exceptions, only individuals can be shareholders in an S corporation; other corporations or partnerships are ineligible to invest in an S corporation. Finally, an S corporation can have only one class of shares. This substantially limits the corporations' ability to structure different rates of return for different investors.

---

114. *Accord* M.B.C.A. § 14.30(2).

115. *Accord* M.B.C.A. § 14.30(3).

The only way to regulate rates of return is to give different shareholders a different number of shares. Other than that, all shares must have equal rights to share in the profits and losses of the corporation. In certain circumstances, the I.R.S. and courts have even declared certain forms of debt to be disguised classes of equity investment that render the corporation ineligible for S corporation status. Share transfer restrictions may also run afoul of the restrictive S corporation rules.

If an S election is timely filed,<sup>116</sup> the corporation is then subject to taxation under subchapter S of the Internal Revenue Code. Subchapter S can be extremely complicated and will not be discussed in detail here. Some of the important attributes of subchapter S are that: (1) there will be no corporate income tax imposed; (2) shareholders will be taxed on amounts allocated to them; and (3) special allocations of income or loss are prohibited.

#### b. C Corporation

A C corporation is any corporation which has not made a valid S election. In other words, if a corporation is formed under state law and no special effort is made to elect special tax treatment under subchapter S of the Internal Revenue Code, the resulting entity will be a C corporation. This is true regardless of whether the corporation is formed under traditional corporation statutes or the newer statutory close corporation provisions. An entity formed as a corporation under state law may not elect to be taxed as a partnership under current tax regulations.

A C corporation is technically subject to double taxation. In other words, net income at the corporate level is subject to an entity level tax. When the corporate income is distributed to shareholders in the form of dividends, the dividends become ordinary income to the shareholder and are subject to personal income tax. To prevent the corporation from retaining earnings endlessly and thereby deferring the second level of tax indefinitely, the Internal Revenue Code imposes a special tax on excess retained earnings.

This does not mean there are no planning mechanisms which can limit the effect of this double taxation. If the shareholders are also the primary employees of the corporation, rather than paying out corporate income in the form of dividends, the shareholder/employees may be paid larger salaries or bonuses. Although the salaries are still taxable at the shareholder level, employee compensation is an expense for the corporation and is paid out of pre-tax dollars.<sup>117</sup> Similarly, shareholders may lend money to the corporation. Interest payments by the corporation are deductible to the corporation, and so the only tax imposed is at the shareholder level.<sup>118</sup> If the shareholder rents property to the corporation, rental payments are also subject only to tax at the shareholder level. These mechanisms can be very successful for smaller corporations in avoiding the double tax burden technically imposed on corporate earnings.

One drawback which is not as simple to plan around is the fact that corporate losses are not deductible at the shareholder level. Although the corporation can carry forward losses to offset future income, and under certain circumstances a shareholder may be able to declare a loss on the value of his or her shares if the corporation is liquidated at a loss, it is not generally possible for a shareholder in a C corporation to utilize corporate losses to offset personal income on a yearly basis.

---

116. Elections must usually be filed at both the federal and state levels.

117. I.R.C. § 162(a).

118. I.R.C. § 163.

## D Cooperatives

### 1. Business Law Status

#### a. Introduction

Cooperatives, or co-ops, are a relatively common form of business enterprise in the agricultural sector.<sup>119</sup> Readers may be less familiar with this organizational option because it is a relatively specialized form of enterprise, and there are far fewer cooperatives than there are corporations, partnerships or even LLCs. While cooperatives can and have been formed by consumers, producers, and workers, in no arena has the cooperative form of business been more important than in agriculture.<sup>120</sup> At least four types of agricultural cooperatives have developed in the United States: production, marketing, purchasing, and service cooperatives. Many modern cooperatives combine two or more of these functions, and some of the rules and characteristics traditionally associated with cooperatives are changing.

The small farming operation that is simply interested in setting up an ownership structure to facilitate investment opportunities, establish effective management, or to enable the efficient transfer of ownership as part of an estate plan, is not likely to be interested in the cooperative form of business. However, a group of farmers or others in the agricultural sector may be interested in forming a cooperative venture in order to facilitate production or marketing arrangements or to take advantage of economies of scale in connection with purchasing of goods or arranging for services.

All of the other forms of business described herein are suitable for ownership of individual operations; the cooperative form of business is not. Nonetheless, because of its historical importance to agriculture and its potential application in a wide range of agricultural settings, it will be considered here.

#### b. General Comparison with the Corporate Form of Business

Traditional cooperatives are often compared to corporations, perhaps because co-ops are typically incorporated under state law.<sup>121</sup> In addition, the corporation offers a convenient point of comparison because corporations are so much more common and better understood.

Persons wishing to become equity participants in a corporation buy stock. Stock in such a venture gives the owners the right to elect directors, generally on the basis of the number of shares

---

119. By 1995, the gross value business volume of American farmer cooperatives amounted to \$112.3 billion. Charles A. Kraenzle, *Non-patronage Business Reaches \$17.9 Billion*, RURAL COOPERATIVES 30 (Mar./Apr. 1997) ([http://www.wisc.edu/farmer/64\\_2\\_30.html](http://www.wisc.edu/farmer/64_2_30.html)).

120. Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 246 (1982).

121. USDA, *Cooperative Principles and Legal Foundations* 1 (1977) (citing Evans & Stokdyk, *The Law of Agricultural Marketing* (1937)).

owned.<sup>122</sup> Share ownership also entitles the owners to share in earnings on a pro rata basis.<sup>123</sup> Absent agreement among the shareholders to the contrary, shares are freely transferable and capable of appreciating in value as the value of the corporation increases. These are, in fact, the essential attributes of corporate "stock" identified by the U.S. Supreme Court in the context of determining when "stock" will be considered to be a security under the federal securities laws.<sup>124</sup>

Cooperatives do not generally share these characteristics. First, cooperatives may or may not issue "stock" to their members; equity participation in a co-op takes many different forms. In addition, while members may be required to buy some sort of "membership interest" as a condition to joining the cooperative, the majority of a traditional cooperative's equity comes from retained patronage earnings rather than external "investment" in stock or other ownership interests. Finally, even where "stock" is purchased, its function is typically only to give members the right to use the co-op's services and facilities. It does not determine voting rights or the right to share in profits from the venture, if any. Cooperatives generally operate on a one-vote per member basis, regardless of the relative investment of the members or the number of shares or membership interests owned.<sup>125</sup>

Similarly, although members generally have equal voting rights in the cooperative, member income is based on patronage rather than equity ownership.<sup>126</sup> Distributions upon dissolution are also based on patronage rather than the members' proportionate capital investment.<sup>127</sup> Finally, membership rights (however denominated) are not usually freely transferable and typically do not have the potential for appreciation.

---

122. Corporations may also issue non-voting shares, but at least one class of shares must have equal voting rights. For a more thorough discussion of corporations, see *supra* part C.1. of this article..

123. Again, it is possible that the corporation will issue multiple classes of shares, each with different participation rights. However, in most states every share in the same class must entitle its owner to the same rights as are attributable to every other share in the same class.

124. *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), identifying the following characteristics "usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." *Id.* at 686, citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975).

125. James Baarda, *State Incorporation Statutes for Farmer Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 30, § 11.01 and Table 11.01 (Oct. 1982).

126. Thus, when a cooperative desires to return some of its net earnings to its patrons, it generally pays out patronage "dividends" (in cash or other property). Earnings returned to persons using the cooperative may also be known as patronage refunds, but are labeled "patronage dividends" in the Internal Revenue Code. I.R.C. § 1388(a). For convenience, the term patronage dividend will be used in this article.

However, the cooperative often does not pay out all of its earnings when they are earned; rather, the typical cooperative will retain at least a portion of each member's patronage dividends until a later date. Patronage dividends that are allocated to patrons but retained by the cooperative are generally known as a patronage retain or retained equities.

127. Statutes addressing the distribution of assets by an agricultural cooperative at dissolution apportion them in three ways: 1) according to property interests; 2) according to stock ownership; or 3) according to past patronage. See Baarda, *supra* note 125, § 17.03.02 and Table 17.03.02.



Four “operationally-unique cooperative principles” have been identified as being essential to the cooperative form of business.

“First, cooperatives are owned and democratically controlled by the producers who use their services. Second, the cooperative distributes its net income to producers in proportion to their use of the cooperative. Third, returns on ownership capital are limited. Fourth, producers who use the cooperative substantially finance its operation.”<sup>128</sup>

This litany of attributes makes for ready comparison with the traditional, for-profit corporate form. In the case of a corporation, shareholder-owners generally have one vote per share, meaning that voting rights are held proportionately to each shareholder's equity investment in the enterprise. In addition, a shareholder's equity interest is typically acquired through investment in the stock itself, although the stock may (and hopefully will) appreciate in value. The investment may be recouped through dividends, or upon sale of the appreciated stock on the open market. Most stock is not redeemable, nor is redemption the typical way in which the value of an investment in corporate stock is realized. In general, therefore, a stockholder's income is generally based on stock ownership, as is the stockholder's right to participate in distributions upon dissolution and liquidation. The shares are generally freely transferable, unless the shareholders have agreed to limit this right. Moreover, there is generally no requirement that the owners of a business corporation “use” the corporation's facilities or products.

Although most cooperatives are incorporated under state statutes which specifically authorize their formation, the relationship between a cooperative and its members is more complex than that which typically exists between a corporation and its shareholders. An incorporated agricultural cooperative is a singular type of business organization, created not only through organizational documents filed with the appropriate state officials, but also through contractual relationships between the cooperative and its members. These relationships involve mutual dependency: the members depend upon the cooperative and the cooperative depends upon its members. The purpose of this structure may relate to the provision of services or to fulfill marketing, processing or supply functions.

#### c. The Essential Attributes of the Traditional Cooperative

As mentioned in the preceding section, there are four attributes which generally typify the traditional cooperative structure:

1. Cooperatives are owned and democratically controlled by persons who utilize the cooperative's services (sometimes called patrons).
2. The cooperative distributes its net income to patrons in proportion to their use of the cooperative rather than in proportion to their equity investment.
3. Returns on ownership capital are limited.
4. Patrons who use the cooperative substantially finance its operation through retained earnings.

---

128. *Id.*

A consideration of each of these four attributes can offer significant insights into the nature of a cooperative.

d. Ownership and Control of a Cooperative

Generally speaking, members in a cooperative are required to make at least a token financial investment upon joining the cooperative.<sup>129</sup> For agricultural cooperatives, membership is typically limited to those who produce the agricultural products which are the focus of the cooperative venture in question.<sup>130</sup>

Often a relatively small initial investment in the venture is all that is required of members. For cooperatives with stock, this investment often takes the form of a mandatory purchase of common stock.<sup>131</sup> Typically, members are expected or allowed to buy a single share of such stock. On the other hand, because cooperatives may be formed on a stock or non-stock basis, the initial investment by members may not result in the issuance of "stock," and instead may take the form of a straightforward membership or initiation fee.<sup>132</sup> Even for cooperatives organized on a stock basis, membership or initiation fees may be required in lieu of a mandatory purchase of stock or in addition to it. However, for the most part, these fees give rise to the same rights that purchasers obtain upon buying membership interests in the form of stock.

This membership typically gives each member of the co-op an equal right to participate in its management. Hence, the cooperative is often heralded as a particularly democratic form of enterprise because the level of investment does not change the voting power of any member.

e. Income Distribution in a Traditional Cooperative

In a traditional cooperative, members or patrons generally share in the co-op's earnings in proportion to their utilization of co-op services relative to that of other co-op patrons. Thus, the right to share in profits depends not on the member's initial investment in the enterprise but on the level of that member's use or patronage. Moreover, while the co-op may refer to amounts paid to members as "dividends," this does not mean that such payments are calculated like typical corporate dividends, that depend on the number of shares owned. Rather, these are patronage dividends,<sup>133</sup> which depend on the level of each member's patronage relative to the levels of patronage of all other members.

---

129. Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 242 (1994).

130. Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 69 (2000) (noting that "the purchase of equity is often limited by statute to the cooperative's member-patrons...").

131. See generally Neil E. Harl, 14 AGRICULTURAL LAW § 133.01[1] at 136-4 (Matthew Bender, Nov. 1996).

132. Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 239-45 (1994).

133. As mentioned earlier, such earnings returned to persons using the cooperative may also be known as patronage refunds, but are labeled "patronage dividends" in the Internal Revenue Code. I.R.C. § 1388(a).

Members do not generally share in 100 per cent of the cooperative's earnings. Each year, the board of directors determines how much of the net earnings to allocate to patrons as patronage dividends. At the end of each fiscal year the cooperative typically "declares" sums retained in excess of costs and payable to members. Under current rules, the cooperative must pay at least a certain minimum of such available funds if it wishes to qualify for special federal income tax treatment.<sup>134</sup> Any earnings not allocated are retained by the cooperative as unallocated reserves. These "patronage retains" are then used to fund co-op operations.

Retained equities are returned to members as provided by the cooperative's bylaws or other written agreement between the cooperative and a particular member.<sup>135</sup> Such bylaw provisions may give the board of directors discretion to call for the payment of equities, may establish a definitive equity redemption program, or may include a combination of such provisions. In addition, state statutes may also affect the redemption of equities.

Although not all cooperatives have specific, systematic plans for the retirement of retained equity, those co-ops that do have such a plan in place generally use one of three basic alternatives: the revolving fund, the base capital plan, or the percentage of all equities plan.<sup>136</sup> The most prevalent of these is the revolving fund (sometimes also known as the revolving capital plan). This type of plan will typically establish a period of time, usually between seven to fifteen years, for the cooperative to retain patronage dividends or per-unit retains. As these dividends or retains are accumulated, they are allocated to the members' accounts. All members who accrue equity during any given year are treated alike and will be repaid after the period of years established by the plan. The plan will therefore pay the oldest equities first and chronologically thereafter in the order that they are accrued. State statutes may modify the typical payout by requiring payments to certain qualifying persons (such as deceased or inactive members) out of order. Obviously, if the cooperative has insufficient funds to pay off all allocated retains that are "due" to be paid in a given year, such repayments will have to be deferred.

It is also possible for a single cooperative to have more than one revolving fund plan at the same time. If a cooperative wishes, it is possible to distinguish among the amounts owed to members based upon the sources of the investment. For example, marketing cooperatives may distinguish fund plans by the type of commodity marketed. Supply cooperatives may distinguish among the plans by sorting them based upon major products supplied or by membership and nonmembership in the co-op. The various plans will often have differing payout schedules.

The second option for equity redemption by cooperatives is slightly more complicated. For cooperatives wishing to establish a base capital plan, the cooperative first establishes a base period, generally five to ten years. The base period represents the period of time over which each member is expected to assist in financing the cooperative based upon current levels of useage. Each year, the

---

134. I.R.C. §1388.

135. These amounts go by many names, such as deferred patronage refunds, patronage refunds, patronage dividends, final pool settlement, net margins, net savings, capital credit, book credits, certificates, revolving fund certificates, certificates of equity, and certificates of ownership.

136. The following information on the ways in which retained equities are typically retired or repaid comes from Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 253-54 (1982). See also Sharlene F. Roberts-Caudle, *Agricultural Cooperative Member Equity: You Don't have to Die for it!* 7 SAN JOAQUIN L. REV. 1 (1997).

cooperative projects its capital needs for the coming fiscal year and determines the amount of equity it needs to withhold from patronage dividends or per-unit retain allocations. For each base period, the cooperative calculates both the total monetary value of all business done with the cooperative and the value of each member's business with the cooperative. The value of each member's use of cooperative services is divided by the total value used, and the resulting percentage represents that member's proportionate use of the cooperative's services during the base period. Next, each member's percentage is multiplied by the amount of needed equity. This establishes a suggested share of equity which should be invested by that particular member. This amount is then compared to the amount of equity that the individual member has actually invested in the cooperative to determine whether the patron is underinvested or overinvested. The cooperative will then redeem more of the equities of the overinvested patrons and retain more of the current year's equities of the underinvested patrons.

In the third major scheme for redeeming members' equities, the cooperative simply retires a portion of all of the outstanding equities each year. To determine the total amount to be redeemed, the cooperative calculates the funds available for the redemption and divides this amount by the total allocated equity which is outstanding. The resulting percentage is then multiplied by each member's equity. Because this arrangement by itself never results in the complete redemption of a deceased or inactive member's equities, this type of plan is generally accompanied by provisions for retirement in full, after a given period, of the accounts of deceased or inactive patrons.

If there is no plan, the directors generally have wide latitude in making decisions about whether and when to redeem retained equities, making this an issue that can lead to disputes between dissatisfied members or former-members and the co-op's directors. However, courts are generally reluctant to intervene in business decisions made by a co-op's directors,<sup>137</sup> particularly where the co-op's own organizational or operating documents gives the directors discretionary authority.<sup>138</sup>

---

137. The business judgement rule is a judicially-created doctrine which shield most board decisions from judicial scrutiny. A court will, however, intervene if it determines that the board or officer acted outside the scope of office, with gross negligence, or was guilty of culpable mismanagement. *Parish v. Maryland & Virginia Milk Producers Ass'n*, 277 A.2d 19, 48 (Md. 1971). Similarly, there may be legal redress if the director affirmatively abused her or his discretion. *Lake Region Packing Ass'n v. Furze*, 327 So. 2d 212 (Fla. 1976). The court in this case held that "corporate directors generally have wide discretion in the performance of their duties and a court of equity will not attempt to pass upon questions of the mere exercise of business judgment which is vested by law in the governing body of the corporation." *Id.* at 216. If members "can demonstrate that the directors of the Association abuse their discretion or breach their trust by establishing charges to the producers at an inordinately low rate in relationship to the competitive market, by permitting the accumulation of excessive reserves, or by any other conduct, respondents have recourse to the courts ...." *Id.* at 217.

138. Courts have uniformly upheld redemption decisions made by boards of directors where decisions were subject solely to director discretion and such discretion was authorized by the relevant cooperative statutes and bylaws, although board decisions must comport with the business judgment rule standard. See, e.g., *Lake Region Packing Ass'n v. Furze*, 327 So. 2d 212 (Fla. 1976) (former members unable to force distribution of deferred patronage refunds where bylaws and articles gave discretion to the board); *Claassen v. Farmers Grain Coop.*, 490 P.2d 376 (Kan. 1971) (board of directors given discretion to refuse member permission to withdraw interest from the cooperative if, in the opinion of the cooperative, it might disturb the financial condition of the cooperative, even though other member's interest had been redeemed upon death); *Driver v. Producers Coop., Inc.*, 345 S.W.2d 16 (Ark. 1961) (although court forced board of directors to comply with the charter and bylaws which set a scheme for retiring former members' interests, board still allowed to exercise discretion).

Generally speaking, members have limited rights to share in earnings of a cooperative; those rights are substantially divorced from the level of their investment and are, instead, dependant on patronage.

Distributions upon dissolution are also typically based on patronage rather than the members' proportionate capital investment. Members generally are not entitled to transfer their membership interests to third parties, and instead must rely upon the co-op to repurchase or redeem their interests. The amount paid generally depends primarily on the level of patronage retains that have accumulated.

f. Returns on Ownership Capital Are Limited

The third characteristic traditionally associated with the cooperative form of organization is that returns on ownership capital are limited. There are multiple reasons why members do not expect a greater return on their investment or ownership interest.

First, the traditional cooperative is inherently not-for-profit, and thus there is often not much in the way of "returns" available to be allocated to capital. Traditional cooperatives exist only to provide economies of scale or other economic benefits to those who use the co-op and its services. It is generally not geared towards making a profit on invested funds. Any retained equities or per-unit retain allocations arise from the provision of goods or services by the co-op, such as marketing of members' produce. Such funds are simply monies withheld by the cooperative from the purchase price of the crop it marketed for its members.<sup>139</sup> These amounts are not "profits," as such.

Second, returns are allocated on the basis of patronage and not as a return on the members' capital investment. This may be just a different way of looking at the same point that was discussed above. If the only "earnings" are those attributable to retains that would otherwise be owed back to the members as a result of a transaction conducted for the member, it is not surprising that eventual allocations to the members do not involve anything that would qualify as a "return" on their capital investment. And without such a return, the investment itself is not worth much in its own right.

In addition, there are various statutory and regulatory barriers to paying out significant amounts as a return on capital. For example, in order to qualify for favorable tax treatment, a farming cooperative that issues capital stock may not pay interest on that stock at any rate in excess of the greater of "the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued."<sup>140</sup> Similarly, the Agricultural Marketing Act<sup>141</sup> defines cooperative association in such a manner that only associations which pay either per cent or less on stock or membership capital are covered. State laws may impose additional restrictions on dividends or interest on capital.

---

139. "The sole return on this capital is reflected in the proceeds received by the producer from the sale of [the products]." Mid-American Dairymen, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,110 (Feb. 2, 1977).

140. I.R.C. § 521(b)(2).

141. The Agricultural Marketing Act is codified at 12 U.S.C.A. § 1141 *et seq.*

Fourth, traditional cooperative ownership interests are generally not freely transferable. Thus there is little, if any, possibility of appreciation, since members are typically prohibited from transferring their stock or membership interest to anyone other than the cooperative itself, which will generally do nothing more than buy back the stock or membership interest at its original purchase price.

g. Traditional Financing for Cooperative Operations

Regardless of whether or not the initial purchase is in the form of stock, most of the equity<sup>142</sup> in a traditional cooperative is generated by the cooperative's retention of a portion of the sales price of goods sold through the cooperative or a portion of any savings realized as a result of purchases through the cooperative.<sup>143</sup> Members in the cooperative are normally entitled to receive shares of the cooperative's earnings based on how much they use the cooperative's facilities or services. Many agricultural cooperatives simply retain a portion of the amount which would otherwise be paid to the members for their product on a per unit basis. This form of "investment" is often referred to as a patronage retain and may or may not be represented by certificates.<sup>144</sup> An important aspect of cooperative financing is that no interest is paid on the monies held as retained equities.

The prevalence of this as a method of financing is attributable to a number of factors. First, although cooperatives are required by federal tax laws and state incorporation laws to pay patronage dividends each year to their members,<sup>145</sup> they are not required to pay the entire dividend in cash.

---

142. There are a number of reasons why farmers' cooperatives may be unable to raise sufficient capital by selling membership interests. "Since the purchase of equity is often limited by statute to the cooperative's member-patrons, however, this financing option can be limited. This option is especially limited in times of economic distress when farmers have very little working capital." Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 69 (2000)

In addition, the greater the capital needs of the cooperative, the less satisfactory equity financing may be as a source of operating funds. See Ralph W. Dutrow *et al.*, UNITED STATES DEPT OF AGRIC., FINANCIAL PROFILE OF 15 NEW AGRICULTURAL MARKETING COOPERATIVES 7 (1981) (Agricultural Cooperative Service, ACS Service Report No. 27, May 1981).

One obvious alternative to equity financing is debt. The commercial practices of an agricultural operation, whether it is organized as a cooperative or otherwise, are beyond the scope of this document.

143. Farmer Coop. Service, USDA, Legal Phases of Farmer Cooperatives 471-80 (1976).

144. See generally Mary Beth Matthews, *Current Developments in the Law Regarding Agricultural Cooperatives*, 1 DRAKE. J. AGRIC. L. 173, 174 n.10 (1996), citing Mary Beth Matthews, *Financial Instruments Issued by Agricultural Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 68, March 1988. Accord Harl, *supra* note 131 at § 136.01[1] at 136-5 to -6.

145. See, e.g., I.R.C. § 1388.

For a general discussion of patronage dividends, see Irving Clark & Phillip L. Erickson, *Taxation of Cooperatives*, 229-2nd TAX MGMT. (BNA); Donald A. Frederick & John D. Reilly, *Income Tax Treatment of*

Federal tax laws require at least 20 per cent be paid in money or by qualified check in order for the entire patronage dividend to be a deductible expense for the cooperative.<sup>146</sup> The amount not paid in cash is kept by the cooperative and credited to the member in one of several ways. For example, a member may receive "stock," credit on a capital account, an equity certificate, or some other evidence of his or her retained patronage in the cooperative.<sup>147</sup> Retained patronage dividends (however denominated) thus provide an easy way for members to contribute equity capital to the cooperative.<sup>148</sup> The principal manner of recouping these types of equity investment is through eventual redemption of these interests by the cooperative, rather than by sale of the interests in a market.

#### h. Value-Added or Next-Generation Cooperatives

Beginning in the early 1990's, commentators began to report on the spread of value-added cooperatives, often referred to as new wave or new generation cooperatives.<sup>149</sup> In some ways, these value-added cooperatives operate like traditional cooperatives, but there are some significant differences.

The purpose of these cooperatives is clear: "to develop new value-added products and to gain access to an increased share of the consumers' food dollar."<sup>150</sup> They have appeared "in virtually every sector of agricultural production," including so-called "niche markets" like bison processing, and more traditional arenas such as corn sweetener production, sugar beet processing and pasta production.<sup>151</sup>

Like traditional cooperatives, these value-added co-ops operate on the traditional cooperative principle of one-member, one-vote.<sup>152</sup> Similarly, a very significant motivating factor in the decision to participate in a value-added cooperative is the desire to gain the benefits of membership, typically a guaranteed market for a particular commodity. In fact, membership in such ventures is "typically

---

*Cooperatives: Background*, USDA, Agric. Coop. Serv., Info. Rept. No. 44, pt. 1 (Nov. 1993); Donald A. Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Patronage Refunds*, USDA, Agric. Coop. Serv., Info. Rept. No. 44, pt. 2 (Dec. 1993); and John E. Noakes, *Taxation of Agricultural Cooperatives* in 14 Neil E. Harl, *AGRICULTURAL LAW*, ch. 135 (1996).

146. I.R.C. § 1388(c)(1).

147. See Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 246 (1982).

148. *Id.* at 247.

149. The USDA has published a "guide" to creating next generation cooperatives: William Patrie, *Creating 'Co-op Fever': A Rural Developer's Guide to Forming Cooperatives*, USDA, Rural Bus.-Coop. Serv., Rept. No. 54, (July 1998). So has the Illinois Institute for Rural Affairs: Mark J. Hanson, *Starting a Value-Added Agribusiness: The Legal Perspective* (ILL. INST. FOR RURAL AFFAIRS, Jan. 2000).

150. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996).

151. *Id.*

152. *E.g.*, Robert Cropp, *New Generation Cooperatives Defined*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/bob.html>).

limited to one commodity group."<sup>153</sup> Finally, as with traditional cooperatives, earnings in a value-added enterprise are also distributed to members on the basis of patronage.<sup>154</sup>

The differences between traditional and value-added co-ops, however, may be profound. First, membership in new generation cooperatives is generally "closed" or "restricted," with total membership based on the volume of raw product that the cooperative can adequately process or refine.<sup>155</sup> The attributes of membership also differ from that in a traditional co-op because a member's equity in a value-added enterprise will equal that member's patronage, since a member is generally required to purchase not only a membership interest but also delivery rights. These "rights" (which also entail an obligation to deliver a specified amount of the applicable commodity) may be assigned on the basis of the number of shares of common stock or may depend on the purchase of preferred shares.<sup>156</sup> The delivery rights and obligations may attach as a result of ownership of the stock pursuant to the terms of the cooperative's organizational documents or may be separate from the stock, as part of a contract entered into between the member and the co-op. In any event, the extent of each member's delivery obligations are generally tied to that member's investment level.<sup>157</sup> Thus, while it is true that a member in a value-added cooperative will share in earnings on the basis of

---

153. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 24 (1996).

154. The difference, of course, is that patronage is itself typically linked to equity participation so that earnings in a value-added venture will vary directly with both patronage and investment.

155. Dennis A. Johnson, *Surfing the New-Wave Cooperatives*, 62 no.7 FARMER COOPERATIVES (Oct. 1995) (<http://www.wisc.edu/uwcc/info/farmer/627surf.html>) (Citing "[d]efined or selected membership rather than open membership" as a characteristic of new-wave cooperatives).

156. *E.g.*, Ralph K. Morris, *Legal and Financial Aspects of New Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>).

157. It is also worth mentioning that the delivery obligations do not always guarantee that the member will in fact be delivering the member's own produce. Some members' agreements for next generation cooperatives expressly authorize the cooperative to buy on the account of the member commodities that the member fails to deliver. *See, e.g.*, Golden Growers Cooperative Growers Agreement ¶ 1(a). Such provisions, of course, mean that delivery obligations can be fulfilled with a cash payment. Also, consider the following discussion about the reasons that participants had for declining to purchase or for selling shares in Dakota Growers Pasta Company, a noted next generation cooperative:

All participants agreed that the cooperative's success had exceeded expectations, but it was not clear at the beginning that this would be the case. Inability to raise durum was an important factor in the decision of two of the session participants. Also, there was discussion about the fact that disease problems in the area have made it difficult for farmers to raise durum that meets the standards of the plant. Even farmers who belong or have belonged to the cooperative have not been able to deliver durum they have produced. Rather, they have been forced to purchase elsewhere the durum they were obliged to deliver. Finally, there was some lively discussion about the fact that purchasing these shares is much like purchasing shares in any business, especially in light of the problems members have in growing durum that can be delivered to the plant. One session participant noted that he might prefer to diversify his investments by purchasing stock in companies outside of the agricultural sector.

Kim Zeuli *et al.*, *Dakota Growers Pasta Company and the City of Carrington, North Dakota: A Case Study*, A Report for the USDA Fund for Rural America, 28 (Mar. 1998).



patronage, it is equally accurate to say that the members' sharing ratios are fixed by the members' relative investments.

This difference is also reflected in the nature of a member's investment in a value-added co-op. Because processing most agricultural commodities is an expensive, capital-intensive proposition, "minimum capital requirement for [new generation cooperative] membership is often high."<sup>158</sup> In exchange for a greater initial capital investment, farmers hope for a greater rate of return. Thus, successful value-added co-ops pay out much of their earnings on an annual basis rather than retaining significant amounts.<sup>159</sup> In fact, expansion is typically funded by new investment in additional delivery or membership rights, not retained patronage dividends.

In order to attract more funds up front, value-added deals are generally structured so that the "delivery or membership rights have value and can be traded."<sup>160</sup> With this framework, there is no necessity to wait for redemption by the cooperative in order to recover the initial investment.<sup>161</sup> The market will determine the value of the interests,<sup>162</sup> and members are able to benefit from any appreciation in value.<sup>163</sup>

On the other hand, just as there is an increased potential for profits, there is also increased risk. One farmer, who serves as a board member in a successful value-added co-op, has been quoted as saying that "investing in value-added ag processing 'is just like investing in the stock market. You have to be in it for the long haul, and you shouldn't invest money that you can't afford to lose.'"<sup>164</sup>

---

158. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 19 (1996).

159. For example, Dakota Growers Pasta Company has paid out approximately \$2 per share since formation in 1992. Lon Tonneson, *Are We Rich Yet?* 1999 *The Farmer/Dakota Farmer* 8 (Jan. 1999). Minnesota Corn Processors paid members "\$.30 to \$1 per bushel from 1984 to 1995." *Id.* at 9. In 1996, another cooperative, Golden Oval Eggs produced a return on investment of approximately 44%. *Id.* at 10. North American Bison Cooperative paid \$41.09 per head in 1998. *Id.*

160. *Id.* See also Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996), talking about the transferability of delivery rights in most value-added cooperatives.

161. Robert Cropp, *New Generation Cooperatives Defined*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/bob.html>).

162. *Id.*

163. Ralph K. Morris, *Legal and Financial Aspects of new Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>). For a detailed discussion of changes in market value for some of the most- and least- successful value-added agricultural cooperatives in recent years, Lon Tonneson, *Are We Rich Yet?* 1999 *THE FARMER/DAKOTA FARMER* 8 (Jan. 1999).

164. *Id.* at 12, citing Sandy Ludeman, Minnesota Corn Processors board member.

As described above, there are several characteristics that can be used to distinguish between traditional and value-added cooperatives. One possible list<sup>165</sup> of the distinguishing characteristics of such value-added enterprises is as follows:

1. Substantial equity investment by members;
2. Closed or restricted membership;
3. Delivery rights or obligations tied to equity investment;
4. Recognition of the transferability of delivery rights;
5. Value-added payments made to members as they are earned; and
6. Expansion funded by new investment rather than patronage retains.

These characteristics create a very different type of investment than that made in connection with traditional cooperatives.

First, there is the dollar amount at stake. Value-added cooperatives face potentially significant problems in raising sufficient equity, since a "tremendous amount of capital is required for modern agricultural processing and marketing facilities, so even maximum effort by the farmer-members of new cooperatives is unlikely to generate sufficient equity funds to construct and operate these facilities initially."<sup>166</sup> Because lenders expect equity investors in such enterprises to contribute approximately 50 per cent of the total capital requirements of the venture,<sup>167</sup> this means that initial investments in value-added cooperatives are often quite substantial.<sup>168</sup>

---

165. The list is an amalgamation of items taken from lists of distinguishing characteristics suggested by Ralph K. Morris, Esq., of Doherty, Rumble & Butle in Minnesota, and Dennis A. Johnson, President and CEO of the St. Paul Bank for Cooperatives. See Ralph K. Morris, *Legal and Financial Aspects of new Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>). and Johnson, *supra* note 155.

166. Ralph W. Dutrow *et al.*, United States Dep't of Agric., *Financial Profile of 15 New Agricultural Marketing Cooperatives 7* (1981) (Agricultural Cooperative Service, ACS Service Report No. 27, May 1981).

167. One source has estimated that "most financial institutions will require at least 40 to 60 percent equity from the owners." Cindy Thyfault, *Developing New Generation Co-ops: Getting Started on the Path to Success*, 63 No.4 RURAL COOPERATIVES (July/Aug. 1996) (available online at <http://www.wisc.edu/uwcc/info/develngen.html>).

Another source suggests that most value-added cooperatives "raise between 30 and 50 percent of their total capital requirements" by selling such shares. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996). The same source suggests that "[r]emaining capital requirement are met through debt or the issue of preferred shares." *Id.*

168. Consider, for example, Mountain View Harvest, a value-added cooperative designed to assist wheat growers by purchasing a bakery and transforming the produce "into a value-added food." Dan Campbell, *Show me the Dough*, RURAL COOPERATIVES 24-26 (May/June 1997) (available online at [http://www.wisc.edu/uwcc/info/farmer/64\\_2\\_24.html](http://www.wisc.edu/uwcc/info/farmer/64_2_24.html)). "To join Mountain View Harvest, a grower had to purchase at least one share in the co-op for \$12,500. They also had to pay a \$500 membership fee and agree to deliver 900 bushels of wheat to the co-op for each share purchased." *Id.*

Similarly, Dakota Growers Pasta Company set an initial share price of \$3.90, and members were required to purchase a "minimum of fifteen hundred shares at the initial share price during the cooperative's equity drive." Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996). This translates to a minimum equity investment of \$5850 for wheat growers wishing to participate.

Second, because delivery rights or obligations are tied to equity investment, the member's earnings will depend on the total investment in the enterprise. A value-added cooperative typically ties the delivery rights and obligations of each member to the number of shares acquired by that member. Thus, although payments to the member may be on the basis of patronage (*i.e.*, the volume of commodities delivered), the payments will also reflect the dollar investment made in the business. This makes the payments look much more like traditional dividends, which are tied only to the amount invested and not at all to the level of patronage. Contrast this with the traditional co-op, where payments reflect the level of patronage and are unrelated to the level of investment.

Third, there is a general recognition that the delivery rights in a value-added co-op have a value. This value comes about because membership in a value-added enterprise is generally "closed" or, in other words, limited to a pre-determined number of investors. The number of investors is determined by the total volume of crops or other agricultural goods that can be processed by the co-op. Once investors have purchased the right to deliver that volume of the relevant commodity, the only way to join the cooperative is if an existing member agrees to sell delivery rights or if the cooperative decides in the future to expand and sell additional membership (and delivery) rights at that time. If a particular enterprise is successful, the right to have a guaranteed market for produce and the right to receive value-added payments may be quite valuable. Allowing these delivery rights to be sold on the open market means that there is the possibility of appreciation over the initial cost of investment.

Further enhancing the possibility of appreciation is the fact that most value-added co-ops do, in fact, pay out profits as they are earned. Unlike traditional cooperatives, where the bulk of equity financing comes from patronage retains, a value-added co-op runs primarily on paid-in capital. If the co-op decides to expand, these operations are financed by selling additional equity interests rather than retaining a portion of the business' earnings. This practice makes purchase of an interest in a value-added enterprise more attractive and, if the enterprise is profitable, enhances the price that interest will bring on the market.

## 2. Tax Status

Non-exempt cooperatives are taxed in accordance with subchapter T of the Internal Revenue Code (the "Code"). The general pre-requisite to subchapter T tax treatment is that the business must be "operating on a cooperative basis."<sup>169</sup> The phrase is not defined by the Code or applicable regulations, but case law provides some insight into what is meant by this language. The cases tend to emphasize cooperative principles such as: (1) subordination of capital; (2) democratic control by members; and (3) the right to share in pecuniary benefits based on participation in the enterprise.<sup>170</sup>

---

An equivalent minimum investment of \$5000 was required for investment in 21st Century Alliance Inc. by wheat farmers looking for the opportunity to sell their product as flour. Traci Carl, *Farmers Grow into the Food-Processing Business*, J. REC. (Okla City) (Mar. 11, 1997) (available from Westlaw at 1997 WL 14388141).

The New Horizon Cooperative permits members to deliver corn to the co-op, which is then fed to chicken that lay eggs which are sold on the market. Shares in this co-op were first offered in February of 1999 at \$3,000. Perkins Jerry, *Golden Eggs? Co-ops United Farms*, DES MOINES REG. 3 (Apr. 16, 2000) (available on Westlaw at 2000 WL 4955217).

169. I.R.C. § 1381(a)(2).

170. These three principles were enunciated by the Tax Court in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 308 (1965), which is probably the most frequently cited opinion on the issue. This case held that a workers' cooperative association was entitled to subchapter T tax treatment as a non-exempt

There are multiple tax benefits to achieving cooperative status. First, there are certain amounts that do not have to be included when the cooperative calculates its taxable income. For example, subchapter T provides a deduction from gross receipts for amounts paid out or allocated as patronage refunds.<sup>171</sup> In order to qualify for this special tax treatment, such patronage dividends must be made in accordance with a pre-existing obligation requiring the cooperative to apportion such payments on the basis of patronage, based either upon the quantity or value of business conducted with or for the cooperative.<sup>172</sup> In addition, such payments or allocations must reflect earnings on member transactions.<sup>173</sup>

Second, Subchapter T generally provides a single level of tax to be assessed on cooperative earnings. While members pay income tax on their share of the cooperative's net income, no entity-level tax will be paid on these amounts.<sup>174</sup>

However, income derived from non-member business is recognized by the I.R.S. and the courts as a proper source of income for cooperatives, and is subject to regular corporate tax rules. Under the corporate tax structure, if this income is distributed to members, it is subject to double taxation (once at the corporate level and then again when distributed to shareholders as dividends). In addition, dividends on capital shares are taxable income for non-exempt cooperatives, even if paid from member-derived earnings.<sup>175</sup>

On the other hand, certain farmer's cooperatives are exempt from income taxes under section 521 of the Code.<sup>176</sup> In order to qualify for this exemption, the farmers' cooperative must be "organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for

---

cooperative). The I.R.S. takes the position that 'operating on a cooperative basis' also requires that the cooperative do no more than 50 percent of the value of its business with customers not entitled to patronage dividends

171. I.R.C. § 1382(b).

172. I.R.C. § 1388(a). A pre-existing obligation to return net proceeds to members according to patronage may be implied under law or the terms of the co-op's articles or bylaws. See *Farmers Coop. Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949). See also *Treas. Reg. § 1.1388-1(a)*.

173. I.R.C. § 1388(a). Under subchapter T, deductible patronage dividends do not include amounts paid either (1) out of earnings other than from business done with or for patrons, or (2) out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. *Id.*

174. I.R.C. § 1385(a). In the case of consumer related transactions, no tax need be paid by either the cooperative or its members. I.R.C. § 1385(b). In providing this complete exclusion from income tax, the Senate Report to the Revenue Act of 1962, Pub. L. No. 87-834 stated:

This is in accord with the concept that patronage dividends represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

175. I.R.C. § 1382(c).

176. I.R.C. § 521.

the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses."<sup>177</sup> In addition, if the organization issues capital stock, the interest rate may not exceed the greater of "the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued," and substantially all stock "(other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) . . . [must be] owned by producers who market their products or purchase their supplies and equipment through the association."<sup>178</sup>

Finally, the cooperative is limited in the amount of business it can conduct for non-members and non-producers. The exemption will be available only so long as the association does not market the products of, or purchase supplies and equipment for, nonmembers in an amount exceeding "the value of the products marketed [or supplies and equipment purchased] for members," provided also that "the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases."

Thus there may be significant advantages to structuring an agricultural cooperative in the manner specified by section 521 of the Internal Revenue Code. Even if the cooperative is not tax exempt, there are specialized tax rules which should probably be explained by an expert after review of the specific facts of any given situation.

## **E. Conclusion to Part II.**

The materials in this article focus on the limited liability company (LLC), the corporation, and the cooperative form of business. The sole proprietorship, the general partnership, the limited liability partnership (LLP), the limited partnership, and the limited liability limited partnership (LLLLP) were addressed in Part I of this series.

These materials should make it clear that each of these forms of business offer some advantages and at least some disadvantages. In any given case some of these options will not be available or will clearly be less desirable than other alternatives. Moreover, although the corporation is more likely to be familiar than the LLC, the extreme flexibility of the latter, coupled with generally advantageous tax treatment, makes the LLC particularly promising as a choice of ownership option. The co-op, addressed in the penultimate section of this article, is not appropriate for ownership of a single farming operation but may be of interest to groups of farmers or others in the agricultural sector who may wish to associate to obtain the benefits of economies of scale or risk-sharing benefits of such an association.

Although these materials focus on the typical default rules under state law and the more common variations from those rules, when it actually comes to choosing and forming a business out of which to run an agricultural operation or cooperative, there are likely to be a number of issues that go beyond what is discussed in this article. The expense of formation or of customization should not be overlooked; some of these forms of organization are likely to work well only if experienced legal counsel assists in the preparation of written documentation, which can be costly. Moreover, there are

---

177. I.R.C. § 521(b)(1).

178. I.R.C. § 521(b)(2).

tax and accounting considerations that may also be important in choosing an optimal format for an agricultural (or any other) enterprise. These materials provide only an introduction to these topics.

*This article was prepared in July, 2002.*

*This material is based on work supported by the U.S. Department of Agriculture under Agreement No. 59-8201-9-115. Any opinions, findings, conclusions or recommendations expressed in this article are those of the author and do not necessarily reflect the view of the U.S. Department of Agriculture.*

The National AgLaw Center is a federally funded research institution  
located at the University of Arkansas School of Law

Web site: [www.NationalAgLawCenter.org](http://www.NationalAgLawCenter.org) • Phone: (479)575-7646 • Email: [NatAgLaw@uark.edu](mailto:NatAgLaw@uark.edu)

