

## Optional Structures for a New Rural Business

	<b>Proprietorship</b>	<b>Partnership</b>	<b>Limited Liability Company (LLC)</b>	<b>Subchapter S Corporation</b>	<b>General Business Corporation</b>	<b>Cooperative Corporation</b>
<b>Ownership</b>	1 Owner	Partners	Members	Shareholders	Shareholders	Members
<b>Voting Control</b>	1 Vote	Mutual Agreement	Mutual Agreement	1 Vote/Share	1 Vote/Share	1 Vote/Member
<b>Equity Capital</b>	1 Source	Mutual Agreement	Mutual Agreement	Shareholders	Shareholders	Members/Nonmembers
<b>Earnings</b>	1 Person	Mutual Agreement	Mutual Agreement	Shares Owned	Shares Owned	Patronage
<b>Taxes</b>	Owner	Partners	Members	Shareholders	Firm/Shareholders	Members
<b>Liability</b>	Unlimited	Unlimited	Limited	Limited	Limited	Limited

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### 1. What is limited liability?

“Limited liability” means that someone who is owed money by a business (usually creditors or successful litigants) can only recover assets of the business (cash, property, investments). If a business operates with unlimited liability (sole proprietorship or partnership), persons owed money can obtain a court order permitting them to “seize” the personal assets of the owner(s) as well.

### 2. What is a Limited Liability Company (LLC)?

An LLC is an unincorporated business, created under a special state law (every state now has an LLC law) that operates like a partnership, except each member’s personal financial exposure is limited to his or her investments in the business.

Since January 1, 1997, IRS has allowed an LLC to be taxed as a partnership. Earnings (and losses) pass through the LLC directly to the members as taxable income. (The owners of an LLC are called members, just as in a cooperative).

As in a partnership, members of an LLC are free to create a business arrangement that fits their needs. There are no laws setting out rules for allocating the earnings, assigning investment obligations, or determining how many votes each member has.

### 3. What is single tax treatment?

Single tax treatment means the earnings of a business are only taxed once, as income to the owners. Each of the business structure options qualifies for single tax treatment, except the general business corporation. In a general business corporation, earnings are taxed one time when earned at the corporate level and the remaining earnings are taxed a second time when (if) they are distributed to the shareholders as dividends.

In most single-tax entities (sole proprietorships, partnership, LLC’s, Subchapter S corporations) the earnings (and losses) pass through the entity directly to the owners.

Cooperatives have a degree of tax planning flexibility not available to other entities. For cooperatives, pass-through treatment of some earnings is available but not automatic. Earnings on business with or for patrons, that is allocated to patrons based on the amount of business conducted with the cooperative (patronage-sourced earnings), are deductible by the cooperative and taxable income at the patron level. This creates single tax treatment similar to other business structures listed in the paragraph above.

However, a cooperative has two other options for handling its patronage-sourced income. First the pass-through can be delayed by issuing “nonqualified” patronage refund allocations or per-unit retain certificates. At the time of issuance, a single tax is paid at the cooperative level. In the year of redemption, the co-op is entitled to a refund of the tax it paid in the year the “nonqualified” allocation was made and the patron reports the cash received as taxable income in the year received.

Second, a cooperative can simply decide not to allocate patronage-sourced earnings to the patrons. They are taxed in the year earned at the cooperative level. If they are ever paid out, the funds would be subjected to a second income tax at the recipient level.

Finally, some earnings of a cooperative may not be eligible for single tax treatment. Earnings from sources not directly related to business operations conducted on a cooperative basis (nonpatronage-sourced earnings) will generally be treated the same as income of a general business corporation; that is, taxed when earned at the firm level and taxed again when distributed to member-owners. Examples of nonpatronage-sourced earnings would be profits on business conducted with nonmembers who aren't treated as patrons, earnings on a sideline business not directly related to the co-op's primary business(es), and investments income earned on funds not needed for the annual operation of the cooperative.

#### 4. What is a Subchapter S corporation?

The Income Tax section of the Internal Revenue Code is divided into "subchapters." The rules for cooperative taxation are in Subchapter T. The rules for enterprise zones, enterprise communities, and rural development investment areas are in Subchapter U.

Subchapter S provides single tax treatment for small business corporations. "Small" isn't measured by assets or income, but rather as a corporation with not more than 75 stockholders and one class of stock. Also, all of the shareholders of a Subchapter S corporation must be individuals who are citizens or residents of the United States, estates, or certain trusts. This excludes any corporation with even one shareholder who is a corporation, partnership, or nonresident alien.

Since its enactment in 1958, Subchapter S has provided a vehicle for a relatively small number of people (10 when enacted, gradually increased to 75 today) to form a business that combined single tax treatment available to a partnership with the limited personal liability protection of a corporation.

#### 5. How is the LLC impacting the use of other business structures?

*General Business Corporations* – No direct impact. Large entities that sell stock to the public aren't eligible for LLC status.

*Sole Proprietorships* – Most state laws and the IRS have both blessed one-member LLCs. Thus many sole proprietorships are looking at reorganizing as a one-member LLC to gain access to limited liability.

*Partnerships* – Many partnerships are converting to LLC status. Most state laws and the IRS permit such conversions at minimal cost. Few new businesses are forming as partnerships for the same reason so many existing ones are converting; an LLC operates and is taxed just like a partnership but provides limited liability.

*Subchapter S Corporations* – As a corporation is a separate legal and tax entity from its members, it must be killed off (dissolved) before it can be converted to an LLC. The tax rules for dissolving a corporation make it very costly in many instances. Thus it may not be advisable to convert an existing Subchapter S business to an LLC. But as the LLC doesn't have the restrictions on ownership that apply to a Subchapter S corporation, the LLC is being used increasingly as the vehicle to structure new business that, before 1997, might have been formed as corporations organized to qualify for Subchapter S status.

*Cooperatives* – The direct impact of the LLC on cooperatives depends on how one defines “cooperative.” If one starts with a general concept that a “cooperative” is a business owned and controlled by the people who use its services, then an LLC can simply be another basis for organizing a cooperative.

However, if one requires that a “cooperative” be formed under a state cooperative incorporation law and adhere strictly to traditional cooperative principles such as one-member one-vote and earnings distributions solely on the basis of patronage, then the LLC will likely be seen as a “threat” to cooperatives. This is because some people forming new, multi-owner businesses to acquire it as an LLC where, in the past, they might have formed it as a traditional cooperative.

## 6. Issues to Consider when Deciding to Organize as a Cooperative or an LLC

\* Cooperative status is only appropriate when the owner’s main focus is on procuring goods and services for themselves or marketing products they produce. If they are primarily interested in making money serving the public, then the LLC or some other structure should be used.

\* Several important public policy benefits available to “cooperatives” are not limited to businesses formed under cooperative incorporation laws:

### 1. The limited antitrust protection of the Capper-Volstead Act

- a. All members (voters) must be agricultural producers
- b. One-member one-vote *or* cap on stock dividends of 8% per year
- c. The value of business conducted with members must exceed that with nonmembers.

### 2. Borrowing from CoBank

- a. 80 percent (60 percent for service co-ops and supply co-ops in an urbanizing area) of the votes must be in the hands of agricultural producers.
- b. One-member one-vote or cap on stock dividends of 10% per year or the maximum percentage permitted by applicable state law, whichever is less.
- c. The value of business conducted with members must exceed that with nonmembers.

### 3. Single tax treatment – Available to all LLCs by IRS ruling.

\* The members of an LLC have considerable leeway in structuring the venture. Sometimes too many options can be a bad thing. When working with people to form a user owned and controlled business, these are some of the factors to consider in deciding whether a cooperative or an LLC structure is more appropriate.

1. *Number of Participants.* As a general rule, as the number of potential members grows, so does the presumption that a cooperative will be the better choice. When a cooperative is formed, certain key issues such as voting and the allocation of margins and losses are predetermined. *When more than a handful of people are involved* in reaching unanimous agreement on these types of matters, their natural tendency to fight for their self-interest can lead to protracted, antagonistic discussions that consume the groups' energy and may even kill the venture.
2. *Rate of Turnover.* While most state laws permit LLC members to transfer ownership interests without forcing the venture to reorganize, each membership change can impact the membership consensus over how the LLC will operate. Thus, the more likely that members will leave once the venture is formed, or that new members will join, the better a cooperative might look.
3. *Comfort Level of the Members.* The reason partnerships can easily convert to LLC status is that the partners have a history of working together and settling their differences in a mutually acceptable manner. To them, the LLC is just the old partnership without the exposure to personal liability. They are comfortable doing just business with each other. A cooperative, with its formalized governance structure through a democratically elected board of directors, lets people participate and provide services for themselves when they don't really know each other and even when they can't stand each other. Thus, the less the potential members feel comfortable working closely with each other, the more a cooperative appears to be a better choice.
4. *Sophistication of the Members.* While sophistication is something of an elitist term, I can't think of a better way to express this point. Negotiating an LLC agreement may require that all of the participants understand the potential ramifications of each option they choose. In a cooperative – with its preordained structure and reliance on a select group of first the organizers, and then the directors, to make most of the key decisions – people can just join and use the services without understanding how capital and governance systems operate. The more members that do understand what's going on the better, but it really isn't essential that they all do as it can be in an LLC where every member is usually equivalent of a director with a voice in every policy decision.
5. *Conclusion.* A good rule of thumb is that if a venture looks like it would work as a partnership, it will probably work as either a cooperative or an LLC. Otherwise, it will probably have the better chance for success if formed as a traditional cooperative.