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# **Staff Paper**

## **BUSINESS/LEGAL ENTITIES for FAMILY OPERATIONS**

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## BUSINESS/LEGAL ENTITIES for FAMILY OPERATIONS

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The type of organizational form of the business, whether it is a proprietorship, partnership, limited liability company, or corporation, impacts the legal and operational modes of conducting business. It also has management succession and capital transfer implications for families as they develop their estate plans and bring the family members into the management team.

The best choice of organizational form from an estate planning standpoint may not be the best from an operations standpoint. And, vice versa. Because estate planning and business planning decisions are interwoven, it is best to address both questions at the same time. Otherwise, the resulting plans may be in conflict.

A business entity is the legal structure under which the business is organized and operated. Whether an individual buys, inherits or receives gifts of operating assets or a share ownership of an operating business, the question of business ownership type must be faced. Moreover, the question of the appropriate type of structure reappears as the business grows or additional family members enter the operation. Individuals who originally owned and operated their business as a sole proprietorship may find it desirable changing to a structure which can facilitate multiple owners such as a corporation, partnership or limited liability company.

The sole proprietorship is the most common form of organization since most small businesses are owned and operated by one individual. It has a common law origin which means it is easily set up and can operate anywhere. The business structure is an extension of an individual's rights and responsibility in property ownership and commercial transactions. The partnership also has a common law origin and has many of the characteristics of a sole

proprietorship, but it is a business organized and operated for profit by two or more individuals. These individuals, called partners, develop an agreement which guides them in sharing of property ownership, division of management and labor responsibilities, and sharing of profits and losses. The partnership owns property and operates the business through the actions of the partners. In most states, the partnership need not register with the state if all partners have general responsibility for the obligation of the partnership. When one or more of the partners have a limited responsibility for the obligations of the business, registration of the entity is required with the state.

In contrast, the corporation and limited liability company are of statutory origin, with the laws of the several states prescribing structure, procedure, and conditions of organization and operation. Hence, its inception requires certain legal steps in a set sequence. In addition, the activities of organizations created by statute are closely regulated after operations begin.

An understanding of the characteristics of business organization can assist the family members decide which type of business structure is best suited for the operation and family situation. There is no easy, set answer to the question of which form(s) of business organization is "best". It requires an in-depth analysis of the business environment, resources, size, returns, growth prospects, etc. surrounding the operation as well as consideration of the mission, goals, and capabilities of current and future business associates. The pros and cons of each business organizational structure can be compared with the objectives to select the most appropriate one for the business.

### **Sole Proprietorship**

The sole proprietorship is a business organization owned and operated by and for the benefit of one individual. The legal business entity is not separate from its owner since the assets and liabilities for the proprietorship are one and the same as the proprietor's personal assets and liabilities. If money is borrowed, it is borrowed in the proprietor's name. Lenders

extending credit to the enterprise rely upon the proprietor's personal assets and credit standing. Thus the proprietor assumes personal liability for all debts. If there is any legal judgement against the business for any reason, the proprietor's property as well as any personal belongings or even future income could be subject to attachment to meet the legal obligations. In many family business situations, the family's property is limited to investments in the small businesses property, so there may not be any compelling reason to separate legal liability between business and personal assets. Business risks, however, are causing many small business owners to rethink the merging of personal and business resources.

The income from the enterprise belongs to the proprietor. All commercial contracts and business transactions are done in the owner's name. The individual may hire employees to provide labor or other services to the business, but the proprietor makes the management decisions and decides its course of action. The owner may consult with employees or others before management decisions are made, but final responsibility for all decisions rests with the proprietor.

The source of capital for a proprietorship is the owner's personal investment and reinvestment of earnings. Loans maybe obtained from lenders for purchasing assets, but it carries an obligation for repayment of the loans from future business activities or other personal earnings. In addition to the proprietor's ownership of capital, the business could obtain access to capital through lease or renting from others.

The proprietor's business pays no income tax itself on its earnings. Instead, the taxable income from the enterprise is combined with the proprietor's personal income and income tax paid according to the individual's tax rates. Normal business expenses are allowed against the operation before taxable income is determined.

Since the proprietorship is a one-person business, it follows that the business suffers the same fate as the proprietor and the life-cycle of the business is closely related to the life-cycle of the owner. The proprietorship comes to an end when and if the owner decides to transfer

the interest in the business by sale or gift. Likewise, if the proprietor dies or becomes legally incapacitated, the proprietorship legally comes to an end.

Lack of management continuity associated with a proprietorship places serious limitations on the inter-generational transfer of the business to an heir who has been employed in the business. This is especially true if heirs who are not involved in the business inherit an interest in an operating business. Typically, they desire cash for their portion of the estate and not business property. Thus, upon death of the sole proprietor, it may be necessary to either liquidate part of the business to pay off the heirs who are not involved in the business or else place a debt obligation on business assets to pay off the other heirs. Either way poses potential cash flow difficulties for the business heirs.

In cases where no heirs will operate the business, the assets of the business are either liquidated or leased to another operation. In either case, the original proprietorship ceases to exist and the business resources are converted into another type of investment.

However, if an heir will operate the business after the proprietors death, a properly designed estate plan can usually overcome these potential disadvantages by providing funds for the transfer of assets to the heir or starting the business transfer prior to death. The problem is that some sole proprietors fail to see such problems and thus may neglect heirs who desire to continue the operation.

Despite this disadvantage, the sole proprietorship offers numerous advantages to the small business owner. Probably the chief advantage is its simplicity. For instance, there are few legal formalities or organizational expenses needed to start a business. Decisions can be made faster and more easily than in other types of business organizations as there are no articles of incorporation or partnership agreements that must be followed before making business decisions. Management decisions are up to the proprietor's discretion. These and other advantages are probably the underlying factors for the sole proprietorship being the dominant form of business organization in U.S. small businesses today.

## Partnerships

When two or more individuals decide to own and operate a common business venture, they are forced to consider business organizations appropriate for multiple owners. In profit organizations, this is either a partnership, limited liability company or a corporation. The two or more individuals could own and operate separate proprietorships, but the economic advantages of combined business operation and property ownership are foregone unless they operate in close proximity to each other and gain economies by using jointly owned assets. The operation of separate proprietorships may be considered when only a limited number of combined activities are done together, and capital items can be shared for the common activities. Otherwise a partnership or corporation offers more potential for common business operation.

### What is a Partnership?

A partnership is an association of two or more people who co-own a business for profit. Individuals forming a partnership contribute their capital, labor and skills to the operation and share with each other the management responsibility, capital resources and earnings from the business. Profits and losses are divided among the partners through a partnership agreement according to the contributions made by the partners to the common business venture. There is no set pattern of ownership or operation of a partnership. The state uniform partnership act, federal income tax laws, and other statutes provide the owners of partnerships considerable flexibility for the partners to determine the terms of their business association in the partnership agreement.

The business relationship among individuals who are conducting a common business venture defines whether a partnership exists for tax, liability and operation issues. A partnership has three basic characteristics which distinguish it from other business organizations. A business arrangement is a partnership when two or more people: 1) share

control and management, 2) share profits and losses, and 3) share ownership and control of property.

Any one characteristic in and of itself may not define a partnership, but one characteristic in combination with the others may be sufficient evidence to show the existence of a partnership. For example, two individuals that manage a business together, share profits and losses, and own common property are partners in a partnership. However, the owning of property in itself doesn't necessarily qualify as a partnership. Nor does the sharing of an enterprise on gross receipts basis between a landowner and a tenant indicate a partnership arrangement. But the combination of the three characteristics for a common business venture does define a partnership.

For some purposes, a partnership is a separate legal entity from its owners. It conducts business in its own name and contracts in its own name. A partnership may hold title to property in its own name and be sued in its own name. It is treated as a separate entity by bankruptcy statutes.

In other instances, a partnership is not a separate legal entity. Each general partner, if they assume that responsibility, is liable for partnership obligations for the settlement of debts or judgments against the business. In other words, if the partnership doesn't have enough assets to discharge its legal obligations, its creditors can bring legal proceedings against any or all of the partners to collect any remaining debts. Thus, a general partner can not separate personal assets from those of the partnership, like a limited partner in a limited partnership.

A partner can not be forced to pay the personal debts and obligations of other partners, nor can any creditor force the use of partnership income for settlement of personal debts of a partner. If any partner can't pay personal debts, the delinquent partner's share of the partnership interest may be attached to settle these debts. And the debtor-partner's share of the partnership income may have to be paid to the creditor until the debt is discharged. This

allows the partnership to be able to continue to operate without being hindered by the personal financial problems of an individual partner.

The partnership business entity does not pay federal income tax. However, it must file an information return showing the income and expenses of the business, the names of the partners, and how the partnership returns will be divided among the partners. The profits, losses, capital gains and other tax attributes are allocated to the partners according to the terms of the agreement. The partners then pay tax as individuals on their respective share of partnership income.

### **Kinds of Partnerships**

There are two different kinds of partnerships, general and limited. A general partnership consists of partners who share management decision making, returns, and ownership of the business. Each partner is liable for partnership obligations for the settlement of debts or judgments against the business.

A limited partnership is organized with one or more limited partners and at least one general partner. Limited partners are capital investors in a partnership and may not participate in the business management or operation. The general partners must assume all management responsibility and risk in the business. The limited partners are liable for partnership obligations only up to the amount of their investment in the partnership. The limited partner who does participate in management becomes liable as a general partner.

Limited partnerships are potentially useful in family businesses when one or more partners want to retire from active involvement in the operation, but wish to continue the capital investment in the operation. A capital return can be paid to the limited partners to compensate them for their investment. One or more general partners assume the management and active involvement in operating the business.

### Partnership Characteristics

A partnership has many elements of a sole proprietorship because it is a mere extension of an individual's rights in a proprietorship. Both are characterized by the relative ease of organization and operation. Businesses can be formed and dissolved with few legal restrictions. Flexibility and maximum individual freedom are present. There are no boards of directors, no officers are specified and no formal meetings with minutes are required. The expense of formation and dissolution can be held to a minimum.

As family businesses grow and become more capitalized and complicated, the management responsibility becomes more critical. A partnership business can pool management abilities and capital resources into one business and possibly be more profitable as a result. Individuals can combine their skills to strengthen the business to their mutual benefit. At this point in the growth of the business, it probably requires a more formal structure of the management team with a board of directors, officers, and division of management responsibility like the corporation. Therefore, individual freedom is possible in a proprietorship, but two or more people in a business who operate together, may want the structure to facilitate the smooth operation of the management tasks.

Modernization and labor-saving technology are usually associated with businesses operated by more than one person. For many individuals with limited capital and a desire to avoid hiring labor, a partnership with a family member who has like objectives may be feasible. If two or more individuals pool their capital resources, economies may be possible that were not present in smaller businesses. Likewise, it may be possible for the partnership to obtain larger loans and a better credit rating than smaller, less efficient operations.

Creation of a partnership between family members can become the first step in getting younger people established in a family business. They need an operating business to enter, training and experience in management, and access to capital which can be purchased or obtained as a gift. The senior partners often want to be relieved of some of the responsibilities

involved in operating the business or may be looking forward to retirement. A suitable partnership can help in achieving these goals. The junior partner can benefit from the senior partner's experience and counsel and the business can gain from the new vigor and ideas contributed by a new partner.

Unlimited liability may be a disadvantage in a partnership. The partnership is responsible for business debts, actions and mistakes of each partner. The partners prosper or fail together. For the partner with considerable capital assets outside the business, a partnership may make those assets vulnerable to risks not associated with a limited liability company or a corporate structure. However, for small family operations where partners have limited personal assets and the business carries adequate insurance for unexpected disasters, this disadvantage may not be applicable to the family situation.

Management of the partnership business is usually implied to be shared equally by the partners. For the success of the partnership, it is almost imperative that management be joint to avoid disillusionment resulting from domination by the stronger partner. In some cases, shared management responsibilities results in divided authority and ineffective management. Each is responsible, but no one takes the responsibility to act. Unless a partnership addresses itself to the problem of decisive action, the business may drift with ineffective leadership.

Limited and uncertain business life are characteristic of family businesses where management is provided by the family members. The business is organized and operated for the benefit of the individuals. Once this benefit disappears, through changing goals, death or other circumstances, the business is dissolved. Multiple ownership through a partnership can extend the business life over many generations and make it possible to transfer capital and management to the younger families if plans are made to accomplish this goal.

### **The Partnership Agreement**

A partnership agreement is a statement of the terms under which partners bind themselves to organize and operate until the agreement is changed. Because partners are members of a business family, the agreement deals with the business relationship. Litigation over the agreement usually involves only the members of the partnerships. Therefore, the agreement is written for them. It also serves to communicate the business relationship among partners for creditors, tax authorities, third party business associates and family members not involved in the partnership.

The agreement serves as a blueprint for the organization and operation of the business. It should be specific enough so each partner knows their rights and obligations, but not so detailed that a business decision cannot be made without reference to the agreement. The agreement should include guidelines for future decision making and cover major aspects of the business organization, operation and dissolution.

### **Contributions of Capital and Personal Services**

Partners contribution to the partnership are capital and personal services. Capital contributions consist of cash, personal property or real property. If any or all of the partners operated an existing business prior to formation of the partnership, the partners must decide what capital will become owned outright by the partnership and what capital will be leased to the partnership. If existing capital is transferred to the partnership, the contributing partner loses all personal rights to the items contributed. Compensation for the capital contribution is through residual partnership profits. In some cases, an entering partner may purchase property from the original owner and make a contribution of that property to the partnership. In other cases, each partner has their own property to contribute to the partnership.

An ownership interest in a partnership is indicated by a share of partnership property. This share is determined by the value of property contributed to the partnership when it is

formed and subsequent contributions in future time periods. Unequal ownership of shares in partnership capital are possible and common, especially when one partner has operated more years than another partner. In this case, the partner with the larger capital contribution is compensated for a greater investment through a larger share of residual profits. The entering partner can acquire a larger share of partnership assets at some future date.

An alternative to the partners contributing all their existing property for partnership ownership is a leasing of a partner's property by the partnership. This is the common case in a partnership with respect to real estate. The partner owning the property is the lessor and the partnership the lessee. The lessor receives a payment from the partnership either as cash rent, a share of the products grown, or a share of residual partnership profits. A written lease agreement between the respective parties should detail all the terms of the lease.

Partners contribute their labor to partnership activities. In most cases, partners devote full time to the partnership. If one partner works outside the partnership or carries on another business, the partnership agreement should state how much time can be devoted to outside activities and how much time should be spent on partnership affairs.

Partners usually share management responsibilities equally, but they can allocate specific managerial duties by agreement. A partnership business may be carried on most effectively if management duties are divided on the basis of each partners' interests and abilities. They may be divided by enterprises or tasks to be performed. This allows one partner to specialize in the technical aspects of that area and share the information with the other partners before decisions are made, while other partners specialize in other areas.

### **Distribution of Earnings**

Sharing net profits (losses) is one of the essential elements for the existence of a partnership. Contributions made by partners to the partnership are compensated through distributions, either as salaries (drawing accounts), lease payments assuming property owned

by a partner is leased to the partnership or a split in the residual partnership earnings. The residual partnership earnings can be distributed to the partners or left in the partnership for re-investing and debt servicing.

Periodic distribution of partnership funds can be made to each partner through salaries (or drawing accounts). Salaries are set at a level to compensate partners for labor and management services devoted to the business and provide the funds needed by partners for family living and other personal use. Partners that contribute labor and management equally will generally have equal salaries. Salaries are adjusted at the appropriate levels for partners who have an unequal contribution of labor and management.

Residual partnership earnings after partnership business expenses are subtracted from gross receipts, are divided among the partners according to the partner's contribution to the partnership. If salaries are paid to reflect labor and management services and are subtracted as a business expense prior to calculating net earnings, the earnings represent a return to capital investment. In this case, many partnerships share the residual earnings at the same percentage as the capital contribution. Sharing of residual earnings according to capital contribution treats each partner equitably if this principle is followed. For a partner with a smaller share of partnership capital, a planned acceleration of residual earnings provides incentive for the junior partner to accommodate a larger capital base and stay in the business. Losses are generally shared in the same proportions as profits.

#### **Dissolution of the Partnership Entity**

Partnerships dissolve when a partner ceases to be associated with the partnership. However, dissolving the partnership does not necessarily require liquidation of the business. With properly drawn transfer guidelines in the agreement, the business can continue as a new partnership or as a different business form. Partnerships may dissolve for many reasons. The agreement should provide provisions for the most likely causes of dissolution by outlining

procedures for (1) liquidation and distribution of partnership assets or (2) provisions for purchasing a departing partner's assets.

Causes of dissolution are:

1. Voluntary Dissolution -- a partnership may be dissolved if the partners voluntarily and unanimously agree to do so. The agreement should spell out when this can occur and how partnership assets will be distributed.
2. End of Term -- Some partnerships may be organized for a limited term and be disbanded at that time. If this procedure is desired, a special provision can guide this dissolution.
3. Withdrawal of a Partner -- A partnership cannot function effectively without the consent of all partners. If one partner wants to be disassociated from the partnership, provisions in the agreement can outline the procedure for making the division with limited family friction. The agreement can specify proper motive, time of division and procedure for buying out or liquidating the departing partner's assets.
4. Retirement of a Partner -- Retirement is a planned withdrawal from a partnership. Provisions can specify when the partner can retire under normal conditions, and how the retiring partner will be compensated for his share of partnership assets.
5. Death of a Partner -- Appropriate buy and sell agreements or liquidation procedures can direct the payment to the estate for partnership assets.
6. Various other reasons may result in the partnership being dissolved. Some of these would include incapacity of a partner, expulsion of a partner, and admission of a new partner. Appropriate provisions may cover these situations.

Partners may prefer to liquidate or transfer the business assets upon dissolution rather than to continue the business in its present form. Liquidation can result from a sale of partnership assets to persons or business entities outside the family or a division of assets to partners according to their proportional ownership share. Partners decide how they will divide

the machinery and equipment, livestock, inventory of crops, land and other business assets in the partnership and distribute the assets to the partners in an equitable arrangement based on the value of the items. Any special provisions for evaluating partnership assets or dividing certain property should be given in the agreement.

In most situations, dissolving a partnership will not result in business liquidation, but result in the remaining partners purchasing the departing partner's business assets. These issues must be considered in partnership dissolution:

1. When a partner leaves the partnership, it can be mandatory or optional for the remaining partners to purchase the departing partner's business investment. Usually, the situation requires that the departing partner sell their share of partnership assets.
2. Values must be placed upon the departing partner's partnership interest. Various methods are available to establish this value at the time of departure through appraisers, book values or by agreement. Because prices change rapidly, market values are usually used. The partnership could annually determine (by mutual agreement) a fixed buy-out value. An advantage of this procedure is that values are certain and determined by the partners themselves. The major disadvantage, in practice, is that values change rapidly and partners fail to update the agreement to reflect these changes.
3. Financial arrangements must be established for payment to the departing partner. Cash settlement is usually preferred, but generally, the remaining partners do not have enough savings to follow this alternative. Remaining partners could borrow the money from commercial lenders, but this might put them deeply into debt, or make it impossible for them to borrow the desired amount. Reimbursing the departing partner in installments may be preferred. The terms of the settlement, interest rates, payment period, number of payments and security should be spelled out.

In case of death of a partner, partnership life insurance may serve as a method to finance the purchase. The insurance provides liquidity at death for the remaining partners to make the purchase. If life insurance is used, the agreement should specify the kind and amount of insurance, who pays the insurance premium, what happens to the insurance policy if a partner departs other than through death, and who receives the insurance benefits. Usually, partners insure each other with the purchaser being the beneficiary. If partnership funds are used to pay the premiums, the partnership obtains the cash value when a partner departs for reasons other than death. The individual obtains the cash value if the premiums are paid from personal resources.

### **Why A Written Agreement?**

A written partnership agreement is not required. Oral partnership agreements are common and valid if the characteristics of a partnership are clearly present. Likewise, a partnership may be present even without an oral agreement if the actions of the parties meet the requirements of a partnership. Although partnerships may be successfully operated without a written agreement, it is strongly advised that the agreement be in writing.

The ownership and operational terms of a partnership agreement are not inherent to the business structure, but are reached through the consent of the parties involved. To develop a common course of action, each partner must understand the other's proposal. Through the drafting process, a more complete accord between the parties can be accomplished by detecting and correcting misinterpretations. Writing out the terms fosters preciseness and clarity. It is the end result of the bargaining process.

While the agreement serves as a blueprint for action, the written agreement also serves as a source document for evaluating intentions against the results. It is present as a reminder of the commitment of each partner and should be reviewed for possible changes as conditions change.

Partnerships should be informal and flexible business arrangements. However, writing and signing a partnership agreement contributes necessary formality and stability. It denotes that a business is being created and fosters a businesslike attitude toward the new association.

Many oral agreements are successful because the partners jointly agree upon the decisions facing the business. But there is no assurance that a partner will always be present. The early death of one partner demands the dissolution of a partnership, but how? One way to convey those wishes is through the partnership agreement. It could prevent problems and save money for the estate, as well as insure a procedure for continuing the business, if the surviving partner(s) choose to do so.

### LIMITED LIABILITY COMPANIES

The limited liability company (LLC) is a new form of business entity authorized in most states during the last ten years. The Michigan legislation which was authorized by Act No. 23, Public Acts of 1993 took effect on June 1, 1993, and is the basis for the information in this article. The limited liability company is defined as an unincorporated organization that limits the liability of its owners to their investment in the enterprises while providing them with pass-through tax treatment.

The business entity must have 2 or more members and combines limited liability and taxation by the owners in their personal tax returns rather than the business entity. Currently, both of these characteristics are not available in a partnership, but are possible in a subchapter "S" corporation. The business characteristics of a limited liability company are very similar to a partnership. Individuals pool their capital and labor resources to form a business entity to operate together. They share the management, earnings, and distributions of capital like a partnership. The reasons for dissolution of the business entity and issues to be

addressed in the dissolution of the entity are about the same for a partnership and limited liability company.

### **A New Vocabulary**

An LLC is called a company, not a corporation and the persons who contribute capital to a limited liability company are called "members". The appropriate term for the contributor to a partnership is a "partner" and to a corporation is a "shareholder". The members organizing the entity files articles of organization rather than articles of incorporation, and it is controlled by its operating agreement rather than its corporate bylaws or partnership agreement. Although the characteristics of the limited liability company parallel those of a limited partnership and a subchapter "S" corporation, there are differences in organization and regulation.

### **Legal Characteristics of an LLC**

An LLC is a separate legal entity like a partnership and corporation, distinct from its owners, that has full powers to conduct business in its own name. The business provides management through its members or delegates this responsibility in the operating agreement to an annually elected manager. The LLC's operating rules come from the operating agreement prepared by the members. The operating agreement has the same purpose as the operating agreement prepared by partners in a partnership and corporate by-laws in a corporation. The operating agreement regulates the business activity and the relationship among the members.

Unlike S corporations (covered in the next section), the LLC is not restricted in the number of members nor are corporations, partnerships, pension plans, and other entities restricted from being members. There is no requirement that members personally sign to allow the organization to be taxed as a partnership. Taxation by the limited liability company as a corporation is not possible if the organizational structure prevents it. LLC's are generally

subject, however, to rigorous disclosure, record keeping, and reporting requirements that do not apply to general partnerships.

LLC's allow contributions of capital to be made by members in the form of cash, property, services rendered and it recognizes binding obligations to make such contributions. The contributions of capital and personal services to the business are very similar to the characteristics of a partnership. The leasing of member owned property to the company and contribution of other assets for ownership by the business entity are the same as partnership.

### **Articles of Organization**

Articles of organization are filed with the Department of Commerce to get a limited liability company recognized in Michigan (or the appropriate state agency in other states). The articles of organization shall contain the name of the company, the purposes for which the company are formed, the mailing address for the company and the initial resident agent, a statement if the company will be managed by a manager rather than the members, and the maximum number of years of duration of the company. The name of the company must not duplicate names used for other LLC's, partnerships or corporations and must include the words "limited liability company" or contain the abbreviation "L.L.C." or "L.C".

A limited liability company may be formed for the purpose of rendering one or more professional services by two or more licensed persons. Professional service means a type of personal service to the public that requires as a condition precedent to the rendering of the service the obtaining of a license or other legal authorization. The name of the limited liability company shall contain the words "professional limited liability company" or the abbreviations "P.L.L.C." or "P.L.C."

### **Unique Characteristics of a LLC**

An LLC is a hybrid entity that is taxed as a partnership while providing limited liability protection for all of its members. For federal tax purposes, the income and expenses of an

LLC, like a partnership, pass-through the business entity and are taxed only at the member level. However, all members of an LLC, like the shareholders of an "S" corporation, have limited liability for the LLC's debts and claims against the LLC. No member has the personal liability of a general partner, which is the characteristic of a limited partnership.

A person may become a member of a limited liability company by making a capital contribution which is accepted by the company as prescribed by its operating agreement. A limited liability company must have at least 2 members. A major advantage of an LLC is personal limits on liabilities beyond the investment in the entity. Unless otherwise provided by law or in an operating agreement, a person who is a member or manager, or both, of a limited liability company is not liable for the acts, debts, or obligations of the company.

### **Federal Tax Treatment of LLC**

The state of Wyoming passed legislation authorizing the LLC in 1977, but it was not until 1987 that the Internal Revenue Service (IRS) issued Revenue Ruling 88-76, which ruled favorably on the classification of the Wyoming LLC as a partnership for federal income tax purposes. Other states have passed LLC laws and they also met the revenue ruling which qualifies the company's earnings as partnership tax treatment. Qualification for partnership taxation avoids the double taxation, generally, applied to corporations other than "S" corporations. .

To be treated like a partnership for taxation, the business must have more partnership characteristics than corporate characteristics. The IRS has identified six corporate characteristics: 1) associates 2) an objective to carry on business and divide the gains, 3) limited liability, 4) centralization of management, 5) continuity of life, and 6) free transferability of interest.

Both corporations and partnerships have the first two characteristics. Therefore, IRS laws and regulations look at only the last four to determine if an organization is a corporation

or partnership for taxation. An organization must have more than half of these characteristics to be classified as a corporation. As long as an organization has only two of these four characteristics, it will be classified as a partnership for federal tax purposes.

Since the objective of a limited liability company is the fostering of limited liability to members, at least two of the last three requirements must be avoided. Continuity of life is avoided because the legislation requires that the latest date for dissolution of the company be specified by the organizers when the company is formed. Unlike corporations, limited liability companies do not offer the possibility of perpetual existence.

In order to ensure that partnership tax treatment is preserved, it is important to either decentralize management or restrict transferability of ownership interest. Under the statute, unless other provisions are made in the articles of organization or the operating agreement, assignment of ownership does not entitle the recipient to exercise any rights of a member unless existing members approve the transfer. The articles of organization or the operating agreement can specify unanimous, majority or other member approval for membership transfer.

Decentralized management is another method of satisfying the IRS restrictions. The statute provides for the appointment of one or more managers who do not necessarily need to be owners. Normally, these managers are selected by a majority vote of the members. If no managers are designated, the owners are deemed to be managers, this avoids centralization of management.

In other states, the IRS has also held that the conversion from a limited or general partnership does not effect a termination of the partnership or cause gain or loss to be recognized. The LLC is treated as a continuation of the existing partnership. If the business is operated as a subchapter "S" or regular tax-paying corporation, the corporation must be dissolved and a new LLC entity formed. There may be ordinary and capital gain or loss income tax implications from changing a corporation to a LLC.

## **Management**

Family business owners usually want all owners to be part of the management team. However, a disadvantage of management by owners is that it may lead to greater potential liability because of the managers' authority to make binding commitments on behalf of the company. Decentralization of management may also have undesirable effects on business decisions and management efficiency. If all of the owners of an LLC are managers, they need to address the roles and responsibilities of the management team members and how decisions are going to be made in the enterprise. The management team decision making, roles of team members, and similar issues are the same as those that are faced in a partnership or a corporation.

Centralized management is an option for the LLC. These managers need not be owners. The number of managers, qualification requirements, and procedures for selection are specified in the articles of organization or operating agreement. If not specified in these documents, the statute prescribes that managers be elected by majority vote of the members and that managers may be removed, with or without cause, at a meeting called by a majority vote of the members or by written consent of a majority of the members. Unless otherwise provided in the operating agreement, voting shall be done in proportion to their shares of distributions of the limited liability company.

Managers are expected to act in good faith in the best interest of the company. They can rely on internal and external information in the discharge of their duties and are required to account to the company for their actions. Managers who carry-out generally accepted management requirements are protected from liability for their actions or inactions. Companies may limit potential liability of managers in the articles of organizations or the operating agreement, but may not protect managers from liability for breach of their duty of loyalty to the company or for bad faith or intentional wrongs.

Every manager is an agent of the limited liability company, and can bind the company for its actions, unless it violates the articles of organization, the operating agreements, or the statute. All decisions of the managers must be made by a majority vote unless the articles or operating agreement provide otherwise. The articles of organization can place restrictions on a manager or member for actions without authority from a majority of the owners.

### **Obligations and Rights of Owners**

The contribution of a member to a LLC may consist of any tangible or intangible property including cash, property, services performed, promissory notes, contracts for services to be performed, or binding obligation to contribute cash, property, or services. A contribution to a LLC may be in exchange for a present membership interest or a future membership interest, including a future profits interests, as provided in an operating agreement. If a member fails to contribute promised property or services, the company has the option to require an equivalent cash payment or outline other remedies in the operating agreement.

Distributions of cash or other assets of the company shall be allocated among members in the manner provided in the operating agreement. If an operating agreement does not provide for an allocation, distributions shall be allocated on the basis of the value of the contributions made by each member. Distributions may not be made if the distribution would cause the company to be unable to pay its debts as they become due in the usual course of business or if total liabilities plus preferential dissolution rights exceed asset values. Members may be personally liable for any wrongful distributions received.

A membership interest is personal property. Except as provided in an operating agreement, a membership interest is assignable in whole or in part. Members own a share of the company, but do not have an interest in any specific company property. Members may assign their interests, but the assignee does not become a member of the company, unless

the operating agreement allows it or the other members unanimously consent. An assignment entitles the assignee to receive the distributions to which the assignor would be entitled.

A member may withdraw from a company as provided in an operating agreement or by giving written notice to the company and to the other members at least 90 days in advance of the date of withdrawal. Members who withdraw from the company before it is dissolved are entitled to receive the fair value of their interest as of the date of withdrawal. Members do not have a right to demand noncash distributions and do not have to accept distributions in kind that are disproportionate to their ownership interest.

### **Dissolution of a LLC**

A limited liability company is dissolved and its affairs shall be wound-up upon the happening of the first to occur of the following:

1. At the time specified in the articles of organization or an operating agreement,
2. Upon the happening of events specified in the articles of organization or an operating agreement,
3. By the unanimous consent of all members,
4. Upon the death, withdrawal, expulsion, bankruptcy, or dissolution of a member or the occurrence of any other event that terminates the continued membership of a member in the limited liability company, unless either of the following applies:
  - a. within 90 days after the termination of membership, a majority of the remaining members, voting in accordance to the terms of their operating agreement or according to the share of distributions of the company, consent to continue the business of the company and to the admission of one or more members as necessary; and
  - b. management of the limited liability company has not been delegated to managers, an operating agreement does not allow an assignee to become a member other than by unanimous consent of the other members, and the business of the company is continued as provided for in an operating agreement.
5. Upon the entry of a decree of judicial dissolution.

## Corporation

The corporation is another business organization that can be considered whether one or multiple owners operate a business. Most closely-held family operations are owned by a small number of shareholders who have incorporated the business to enjoy the benefits of corporate organization. There is no established public market for shares in a small corporation and the bylaws usually have restrictions on the sales of stock to individuals outside the family.

The corporate form of business association has several fundamental characteristics which distinguish it from proprietorships, partnerships, and limited liability companies. A corporation is a distinct legal entity, which can be separate and apart from the individuals who own it (shareholders), manage it, and work for it. A corporation is essentially an artificial legal person created according to state law. It has many of the rights of an individual. A corporation can own and transfer real and personal property, sue and be sued, contract to buy and sell -- all in its own name.

A corporation is recognized under state law when the formal requirements are met for registration of business to operate in the state. Each state determines the general purposes for which a corporation may be formed and the procedures that must be followed to establish a corporation. The articles of incorporation are the basic character or governing instrument of a corporation. It contains the powers and limitations of the corporation and its shareholders. The document includes the name and address of the corporation and the shareholders, the purposes for which the corporation is organized, information about the shares of stock and the duration of the corporation.

In addition to the articles of incorporation, corporate bylaws are enacted by the shareholders or directors to regulate the everyday affairs of the corporation. The document is similar to and has the same purpose as the agreement for a partnership or a limited liability company. The bylaws are not filed with the state like the articles of incorporation. Included in most corporate bylaws are the time and place of shareholders' and directors' meetings,

quorum requirements for shareholders' and directors meetings, a listing of officers' duties as well as special limitations on their authority in such matters as borrowing money and entering into contracts, the corporation's tax year, and stock transfer restrictions and agreements.

The characteristic of limited liability for the shareholders is an advantage of the corporate structure. Corporate legal obligations arising either from tort liability (such as negligence) or contractual commitments may be satisfied only out of corporate assets, not out of shareholder's individual assets, unless the shareholder signs personally to guarantee the obligations of the corporation. Thus, the liability of shareholders is limited to the amount of money they have paid or promised to pay into the corporation.

#### **Perpetual Life Characteristic of Corporations**

Another distinguishing characteristic of the corporate form is the possibility of perpetual life of the organization. In other words, a corporation could conceivably go on forever -- it is not dissolved upon the death of its owners as are the proprietorship, partnership, or limited liability company. Upon the death of a shareholder in a corporation, only the corporate stock owned by the decedent is subject to probate -- not the corporate assets. Since title of land and other personal property owned by the corporation are not affected by the death of a shareholder, the operation of the business may continue without interruption if ownership and management succession have been planned. This continuity of existence of a corporation may result in an estate planning advantage over other business entities.

All corporations do not necessarily have to continue forever. Likewise, most closely-held family corporation will continue only if a member of the family provides continuity in management and capital ownership at the retirement or death of the founders. The shareholders could fix the life of the corporation for a certain period of years by stating such in the articles of incorporation.

### **Ownership and Management of Corporations**

A corporation has a measure of flexibility with the shares of stock in the transfer of ownership not available in other forms of business associations. Stockholders may sell or transfer their ownership shares in the corporation without altering the business. For instance, if a large block of corporate stock is transferred, it could change the management control of the corporation. But such a transfer would not affect in any way the assets within the corporation, only the stock ownership of the corporation would be affected. Thus, the corporation could continue to operate as a separate legal entity without interruption. This is in direct contrast, for example, to a partnership where the partnership automatically dissolves whenever a partner ceases to be associated with the business, unless provisions are made to continue the business with the formation of a new partnership.

Another unique characteristic of the corporate form is the way in which it is owned and managed. The owners are called shareholders because they hold shares of interests in the corporation. Corporations issue these ownership shares in the form of stock. There are several types or forms of stock with the most widely used being common stock.

At the time of incorporation, stock is received in exchange for the assets which are transferred to the corporation. Thus, shares of stock represent the specific amount of interest each owner holds in the corporate assets. However, these shares of stock do not represent an interest in individual assets. The corporation owns the assets and shareholders do not have a right to any specific assets owned by the corporation.

Decision-making powers in a corporation are allocated to the stockholders, the directors, and the officers. The owners of stock vote individually or combine in numerous ways to elect a board of directors who set policies of the corporation for the stockholders. The board of directors in turn elect officers of the board who carry-out the functions of the board and hire or appoint managers who are the day-to-day decision makers of the corporation. These officers may in turn hire non-family members as managers and laborers to help operate the

corporation. In most closely-held family corporations, the family members are the officers of the board and the managers of the corporation.

Thus, there could theoretically be five groups of people involved in a corporation: 1) the Incorporators, 2) the Shareholders, 3) Board of Directors, 4) Officers, 5) Salaried Employees and Hourly Wage Earners. The roles for each group are explained:

1. Incorporators -- These are the persons who sign the articles of incorporation and see to it that they are filed in the state of incorporation.
2. Shareholders -- Owners of the corporation. Legally it is the shareholders that exercise ultimate control of the corporation. This control is exercised through voting their shares of stock with one vote for each share of stock. Shareholders hold annual meetings (and sometimes special meetings) to transact such business as electing directors, approving changes in the corporate charter and articles of incorporation, acting on financial reports, and providing general overall guidance to the operation. Any transaction that would alter the corporation in a fundamental manner requires shareholder approval. Examples of such fundamental changes include mergers, consolidation, sale or lease of all the assets, dissolution, and alteration of the stock structure.
3. Board of Directors -- Usually the directors are given broad authority in the bylaws to manage the business for the benefit of the shareholders. Directors are responsible for making operating policy decisions, keeping the corporation in a sound financial condition, recording their business decisions, and selecting the officers. They exercise authority as a group; acting separately as individuals has no legal effect. Decisions are made by majority vote with each director having one vote for board matters regardless of the amount of stock owned. Directors typically receive fees for their service, but are not salaried.
4. Officer -- The officers execute the corporate policy on a day-to-day basis, hence the term executive or manager. Officers often function as full- or part-time employees and receive

salaries. Officers are the agents of the corporation who are authorized and directed to perform regular business duties of the operation such as making contracts, hiring and firing employees, receiving and paying out money, maintaining adequate records of business transactions, etc. Officers may be removed whenever the board feels that it would be in the best interest of the corporation.

5. Salaried Employees and Wage Earners -- Salaried employees are the family members who are employed by the corporation and other employees paid on the basis of a salary rather than an hourly wage. Wage earners are all the other non-salaried employees hired by the corporation to help in the operation of the business.

In large publicly-held corporations, the above groups are separate and distinct from one another. Thus, there is a separation of ownership and management. Practical control of the corporation is removed from the owners by the board of directors. This separation of ownership and management is another unique characteristic of the corporate form, but not of small family operations.

In most closely-held family corporations, the same individuals hold membership in each of the groups. Frequently an individual will wear four hats, that of a stockholder, director, officer and employee. Under these circumstances, ownership and management may be merged in the same persons. However, if a stockholder is also a director or an officer or both and he handles corporate business, he is technically acting as a manager and not as an owner. The reason for this is that stockholders completely lack any right to establish management policy by direct action. They can only influence management of the corporation indirectly through their election of the directors. The separation of ownership and management exists legally in a corporation, even though an owner is also a manager. Thus, it is important to know the separate functions of each group as the law judges the authority and obligations of such an individual according to the specific capacity within which he or she is operating.

### How a Corporation Is Financed

There are two basic sources for financing a corporation: 1) the issuance and sale of bonds, debentures, notes, etc., called debt financing, and 2) the issuance of stock called equity financing. Although the terminology is different, the financing of a closely-held corporation is the same as a proprietorship, partnership, or limited liability company. However, under a corporate structure it may be possible for non-family members to make an investment in the operation. This private placement of money by an investor is arranged by the owners of the corporation.

A bond is a written promise by the corporation to pay a stated sum of money at a specific date accompanied by a stated interest rate. Bonds are normally secured by a lien or a mortgage. Thus, a bond holder is a secured creditor of the corporation. Some bonds are designed so that it is possible to convert them into shares of stock of the corporation. A debenture is a debt instrument similar to a bond except that it is unsecured.

The ability to issue various classes of stock and debt instruments provides a corporation greater flexibility in arranging the capital structure than possible with a sole proprietorship, partnership, or limited liability company. Through the use of debt instruments in addition to stock, investments can be made in corporations without changing the control of stock ownership.

Corporations can also borrow money, just like other business entities would. One would think that the incorporation of a business would increase its attractiveness to lending associations because a corporation is of greater permanence (it can have perpetual life) than the other forms of business organization. However, this typically is not the case since management of the corporation is of greater concern to lenders than is perpetual life. Thus, the ability to obtain credit from a credit institution is usually not affected by incorporation of small family operations.

### **Federal Income Taxes**

The two types of corporations are regular corporations (also referred to as Subchapter "C" corporations) and tax-option corporations (also referred to as Subchapter "S" corporations). Both types are separate legal entities. Their difference lies in the method of federal income tax payment.

A corporation taxed under the regular method of income taxation is considered a separate taxable entity -- it becomes a legal, tax-paying "person" itself. It pays its own income taxes at tax rates established for a regular corporation. Amounts paid by the corporation as salaries, wages, rents, and interest are deductible by the corporation as expenses when figuring taxable income. Every person -- stockholder or not -- who works for the corporation becomes an employee. Being an employee, they must pay personal income taxes on their wages -- just as all employees are required. Stockholders must also pay personal income tax on any other income received from the corporation such as rent payments on property leased to the corporation or interest received on corporate debentures.

A disadvantage of Subchapter "C" corporations is that double taxation is possible. It occurs when corporations pay dividends to their shareholders since dividends are distributed from the corporation's after-tax income and are not a deductible corporate operating expense. Shareholders must include dividends in their taxable income. Thus, shareholders are in effect paying taxes a second time on the same profits.

Most closely-held corporations avoid paying dividends because of the double taxation. Many corporations strive to pay out all "profits" as salaries, bonuses, rents, interest on debentures, or wages to stockholders, thus avoiding double taxation.

If a corporation elects to be taxed under the special tax option or Subchapter "S" method, it is normally not a taxpayer. That is, the corporation itself is not taxed on any income. The income of the corporation "flows through" to the shareholders and each shareholder includes a prorated share of the corporation's earnings on personal income tax returns. All income is

taxed in the year it is earned whether or not it is retained or distributed. Subchapter "S" rules are similar to partnership rules in that an information return is filed annually on behalf of the corporation.

Thus, corporate earnings in a Subchapter "S" corporation are only taxed once -- to the shareholder. This avoids the double taxation possibility present with Subchapter "C" corporations. However, only certain types of small business corporations may elect to use the Subchapter "S" option. Several requirements must be met initially and on a continuing basis to be eligible.

1. The corporation can have no more than 35 shareholders.
2. Generally, only individuals and grantor trusts or estates of individuals may be shareholders. Partnerships and corporations cannot be shareholders.
3. The corporation must be a domestic corporation (organized under the laws of one of the states or territories of the United States or under federal law) with no non-resident alien shareholders.
4. The corporation may have only one class of stock outstanding.
5. If more than 25 percent of a corporation's gross receipts are "passive investment income", and the corporation has accumulated earnings from years as a regular corporation, the corporation will be taxed at the highest corporate rate on "excessive passive income" (more than 25 percent) and will lose its "S" status if these conditions exist for three years. Passive investment income is rents, dividends, interest, etc. Material participation in the management of the investment converts the passive investment income to earned income. Likewise, this requirement is not applicable if the Subchapter "S" corporation has never accumulated earnings as a regular corporation.
6. All of the shareholders of the corporation must consent to the election.

A Subchapter "S" corporation does not lose its other corporate characteristics. It is a corporation for every other purpose. It hires employees and pays salaries and bonuses in the

usual fashion and may declare dividends to shareholders. Limited liability, transferring shares of stock, employee fringe benefits, and stock purchase agreements, are all similar.

### **Choice of Form of Operation**

The choice of form of operation for a family business is limited to a proprietor, general or limited partnership, limited liability company, or a corporation with two alternative methods of paying its income taxes. In some cases, more than one business entity will be used in the family business with different individuals having separate ownership or type of business in another form of organization. For example, the real estate may be owned in one form of organization and the operating business in another form. Different forms may be used in different states of the development of the business. Hopefully, this brief description of the organizational forms highlighted the important distinguishing features of each organization, so a better choice of form of operation can be made.