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INVITED PAPER

The Impact of LLCs on Cooperatives: Bane, Boon, or Non-Event?

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In recent years, every state has enacted laws enabling businesses to operate in a new form known as the limited liability company (LLC). Recent changes in the way the Internal Revenue Service (IRS) treats LLCs for tax purposes has increased their appeal. Interest in using the LLC model to organize multi-owner businesses is growing so rapidly that some cooperative champions are wondering if this new kid on the block will deliver a knockout blow to cooperatives. Others see it as an exciting new tool to further cooperative enterprise. This article discusses the characteristics of LLCs, provides some background on their evolution, compares them to other ways of structuring a business, and looks at the challenges and opportunities they offer rural residents and their cooperatives.

What is an LLC?

The LLC is a legal structure for organizing a business that provides its owners with the limited liability of a traditional corporation and the single tax treatment of a partnership. The owners are called members, as in a cooperative. Under a typical state law, an LLC is created by filing articles of organization, comparable to a corporation's articles of incorporation, with the appropriate state official. Member rights and obligations are set out in an operating agreement, similar to a partnership agreement or corporate bylaws. The operating agreement covers issues such as management, voting rights, allocation of income and losses, transfer of interests, and withdrawal. Several key traits identify an LLC:

1. An LLC is a state-approved, unincorporated association. Sometimes an LLC is referred to as a "limited liability corporation." This is incorrect. The fact that it is not a corporation is crucial for it to qualify for single tax treatment.
2. Owners, managers, and agents are protected from personal liability for debts and other obligations of an LLC by state law.
3. Earnings (and losses) pass through to the owners for federal income tax purposes under Internal Revenue Service (IRS) administrative rules. The Internal Revenue Code doesn't contain any provision for LLCs that is comparable to Subchapter T for cooperatives.
4. Similar single tax treatment is generally available at the state level. Exceptions exist, so anyone interested in forming an LLC should check carefully in each state where the LLC is subject to taxation to see how it will be taxed.

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A Bit of History

While the LLC is a relatively new form of business organization in the United States, it has been used in Europe and South America since the nineteenth century. For example, the suffix "Gmbh" after a company name identifies a German LLC; "S.A.R.L." a French LLC; and "E.P.E." a Greek LLC. In South America, an LLC is referred to as a "Limitada."

The story of LLCs begins in 1960 when the IRS adopted rules, commonly called the *Kintner* regulations, for classifying unincorporated, multi-owner businesses for tax purposes. IRS identified what it referred to as "corporate characteristics." They were: (1) continuity of life, (2) centralized management, (3) limited liability for owners, and (4) unrestricted transferability of ownership interests. If a business had three or more of these traits, IRS considered it a corporation for tax purposes. If it had two or fewer, it was treated as a partnership.

This approach worked relatively well for seventeen years, primarily because no one attempted to create an unincorporated business structure that provided the owners with broad, limited liability. This changed in 1977, when Wyoming enacted the first limited liability company act in the United States.

The Wyoming law created a dilemma for IRS. It had to decide whether limited liability was so fundamental to the concept of being a corporation that an organization where all owners had limited liability must always be classified as a corporation for tax purposes. IRS studied the issue for eleven years. This created a period of dead time in the evolution of LLCs as the other states waited for IRS to rule on the tax status of Wyoming LLCs.

Finally, in 1988, IRS decided no one corporate characteristic, including limited liability, should be accorded greater weight than the others in classifying a business for tax purposes. Therefore, as with any other unincorporated business, an LLC qualified for tax treatment as a partnership if it had two or fewer of the four corporate characteristics.[1]

This stimulated the states to enact so-called "bullet-proof" LLC statutes. They limited an LLC to not more than two corporate characteristics. For example, the Virginia law defined an LLC as "an unincorporated association, *without perpetual duration*...." It also provided "an assignee of an interest in a limited liability company may become a member *only if the other members unanimously consent*."[2]

As a Virginia LLC was expressly barred from having "continuity of life" or "free transferability of interests," it had to qualify for partnership tax status under the *Kintner* regulations. Therefore, its access to single tax treatment was "bullet-proof" in that it couldn't be "shot down" by IRS agents and auditors.

This opened the door to use of LLCs by sophisticated taxpayers, including some cooperatives who developed LLCs with other cooperative and noncooperative firms to carry out joint ventures. But the process of organizing diverse rural residents into a cohesive business unit within the confines of the *Kintner* regulations was pretty daunting. Many people were left with the Hobson's choice of incorporating to achieve limited liability or forming their business as a partnership to qualify for single tax treatment.

IRS "Check-the-Box" Regulations

A new set of tax rules frees all taxpayers from choosing limited liability or single tax treatment. On January 1, 1997, IRS abandoned the *Kintner* regulations and adopted a self-classification approach for determining the tax status of unincorporated businesses. The new rules are commonly called the "check-the-box" regulations because they permit most unincorporated businesses to choose whether to be taxed as partnerships or corporations. Most don't even have to do that much. They are automatically given the status they want.[3]

The new regulations list entities that have no choice but to be treated as corporations for tax purposes. These include businesses organized under state, federal, or tribal laws that describe or refer to them as incorporated or as corporations. Virtually all existing cooperatives are covered, as they are organized pursuant to a state cooperative or general business incorporation law. Corporate tax status is also mandated for insurance companies and state-chartered businesses conducting banking activity with deposits insured under the Federal Deposit Insurance Act or similar federal statutes.

Any other business with two or more owners may choose to be taxed as a partnership or a corporation. A single-owner business can elect to be treated as a corporation or to be simply disregarded as an entity separate from its owner. For example, a cooperative conducting an activity through a single-member LLC can treat the LLC as a division for tax purposes. All tax consequences relating to the LLC will be included in the cooperative's tax return. A single individual who forms an LLC is taxed as a sole proprietorship unless he or she chooses corporate status.

How LLCs Compare to Other Business Forms

The LLC gives its member owners substantial flexibility in designing financial and governance structures compared to other business forms. When this is combined with single tax treatment and limited liability for members, the total package is an attractive option to people forming businesses. The following are key differences between LLCs and other options:

- Sole proprietorship—An LLC offers limited liability for the owner, protection not available to a regular sole proprietorship. While some states require multiple owners to form an LLC, they are gradually amending their laws to authorize one-member LLCs.
- Partnership—Both a partnership and a multi-owner LLC are generally permitted pass-through, single tax treatment under Subchapter K of the Internal Revenue Code. An LLC provides limited personal liability for all members, regardless of the extent of their involvement in managing the venture. In a partnership, at least one partner actively involved in managing the operation usually is personally liable for its obligations.
- General Business Corporation—Income of a general business corporation is taxed twice, at the corporate level when earned and at the owner level when distributed. An LLC qualifies for single tax treatment; all income and losses pass through to the members. Also, members of an LLC need not comply with corporate formalities such as annual meetings, keeping minutes, and electing directors and officers.
- Subchapter "S" Corporation—Some closely held corporations are eligible for single tax treatment under Subchapter S of the Internal Revenue Code. To qualify, they must comply with restrictions on the number and type of members and can't have more than one class of stock. An LLC has no such limitations.
- Cooperative—An LLC can't delay the pass through of earnings to its members; there is no equivalent to "nonqualified" retains for an LLC. But LLC members can allocate earnings and losses and assign votes among themselves as they see fit.

Some General Implications of LLCs

The emergence of LLCs has interesting implications for people involved in business organization. These include:

- Fewer new businesses will form as partnerships or Subchapter "S" corporations. The LLC offers better liability protection than a partnership and more governance flexibility than an "S" corporation.

- Many existing partnerships will convert to LLCs. Under many state laws, this conversion is relatively easy. For example, Virginia law provides "a general or limited partnership that has been converted (into an LLC) shall be deemed for all purposes the same entity that existed before the conversion."

  The IRS takes the same approach. It has held that the conversion of a partnership into an LLC is a nontaxable event.[4]
- Some corporations will convert to LLCs. However, this is generally treated as a liquidation of the corporation. Tax liability can arise, for example, if property held by the corporation has appreciated in value. This will discourage some corporations from changing to LLC status.

Organizing a Cooperative as an LLC

Whether one views LLCs as a boon, bane, or non-event for cooperatives may well depend on one's perspective of just what a cooperative is. The LLC boom will be disconcerting for those who (1) believe a cooperative has to be organized under a "cooperative" statute; (2) make decisions on the basis of one-member, one-vote; and (3) allocate margins strictly on patronage. They may have to endure a decline in the number and sophistication of businesses meeting their model.

Today many people take a more flexible stance in defining a cooperative. To them, a basic definition of a cooperative can be as broad as "...a business *owned and controlled* by the people *using its services*" (Torgerson 1985). This approach, which focuses on the objectives of the firm rather than its structure, permits a much more constructive response to LLCs.

When accessing the impact of LLCs, the first issue is whether a cooperative can be formed as an LLC. Since no universal definition of a cooperative exists, from a practical standpoint the real question is whether an LLC can qualify as a cooperative for favorable legal treatment important to its members. It presently appears an LLC, if properly structured, can either qualify as a cooperative or provide similar benefits to members.

Antitrust Protection

The Capper-Volstead Act, which provides limited antitrust protection for agricultural producers to market their products collectively, applies to producers acting together in "...associations, corporate or otherwise...."[5] The word "cooperative" never appears in Capper-Volstead.[6] Capper-Volstead does require an association to meet certain organizational and operational standards for coverage:

- the association must be operated for the mutual benefit of the members as producers,
- either no member can have more than one vote because of the amount of capital owned, or, the association may not pay dividends on membership capital of more than 8 percent per year, and
- the value of products handled for members must exceed that of products of nonmembers.[7]

These prerequisites establish the cooperative character of associations qualified for the protection provided. But they don't mandate any particular organizational structure.

Bank for Cooperatives Financing

The standards in the Farm Credit Act for borrowing from the Bank for Cooperatives are similar to those in Capper-Volstead. The scope of the Farm Credit Act is broader, applying to associations that provide producers with farm supplies and business services as well as marketing entities. It also refers to associations of producers that are "operated on a cooperative basis."[8] But its specific requirements are more liberal than Capper-Volstead's:

- either no member can have more than one vote because of the amount of capital owned, or, the association may not pay dividends on membership capital in excess of an annual rate established by the Farm Credit Administration,[9] and
- the value of business conducted with or for members must exceed that conducted with or for non-members.

Also, while the courts have held all members must be producers under Capper-Volstead,[10] the Farm Credit Act only requires 80 percent producer control as a general rule and only 60 percent for utility cooperatives and local farm supply cooperatives in urbanizing areas.[11]

The Farm Credit Administration regulations interpreting this language are equally broad. "Cooperative" is defined as "any association...of producers...that conducts business for the mutual benefit of its members."[12]

The key point here is that neither of these statutes appears to impose any barrier to producers organizing as an LLC and qualifying the LLC as a "cooperative," if they are willing to include provisions in the organizational documents mandating compliance with the standards set out in the laws. More specifically, neither program seems to require that earnings be returned to members on the basis of patronage. Thus it would appear that a group of producers could organize as an LLC, allocate earnings on a mutually acceptable basis other than patronage, and still qualify as a "cooperative" under Capper-Volstead and the Farm Credit Act.[13]

Single Tax Treatment

It may be difficult for an LLC to qualify as a "cooperative" for federal income tax purposes. However, under the "check-the-box" rules, comparable single tax treatment is available.

Internal Revenue Code language granting favorable tax treatment to cooperatives is quite broad, referring to "any corporation operating on a cooperative basis."[14] The Code doesn't define "operating on a cooperative basis." The Treasury Department regulation interpreting this section repeats the Code language and adds the phrase "and allocating amounts to patrons on the basis of the business done with or for such patrons."[15]

At least two hurdles confront an LLC seeking single tax treatment as a cooperative. First, it might not wish to allocate earnings to members *on the basis of patronage*. If earnings are allocated on any other basis, the organization is in conflict with the regulation.

Second, under all state LLC authorization laws, an LLC is not a "corporation." Under "check-the-box," a multi-owner LLC is normally considered an "association" for tax purposes and can choose whether to be taxed as a "corporation" or a "partnership."[16] Most LLCs will choose partnership status to qualify for single tax treatment. But they have the option to choose corporate status to, for example, receive a special tax break that is more beneficial to them than single taxation of earnings.

In summary, some producer associations may be able to gain the major federal statutory advantages of cooperative status while organized as LLCs, without being required to allocate margins on the basis of patronage.[17] This could greatly increase members' flexibility to devise financial plans tailored to meet their individual needs and preferences.

Cooperatives as Members of LLCs

Existing cooperatives have found LLCs particularly useful as vehicles for organizing joint ventures, with both cooperative and noncooperative firms. For example, two major diversified cooperatives headquartered in adjacent Midwestern states, Countrymark and GROWMARK, formed three LLCs to jointly manage their agronomy, production livestock and nutrition, and energy businesses. This has permitted the two member cooperatives to operate these functions more efficiently while maintaining separate approaches when dealing with their individual members (Werner 1997).

Today most joint ventures are formed as partnerships or LLCs. In either case, the tax treatment of the joint venture will be determined under the partnership rules of subchapter K.[18]

For the cooperative(s) in a joint venture, a crucial question is whether earnings and losses that pass through the venture entity to them are patronage sourced and thus deductible for tax purposes when allocated to their members as patronage refunds. Thus far, no administrative rulings or court decisions have discussed this issue in the context of an LLC. However, a generally acceptable standard has evolved that will likely be applied when the matter is reviewed. It consists of looking at the transaction or activity generating the income and asking whether it is "directly related to" or "actually facilitates" the cooperative's overall business purpose. If the answer is "yes," then the earnings (or losses) are patronage sourced.

The "directly related" test is based on Treas. Reg. § 1.1382-3(c)(2), which states, in part: "'Income derived from sources other than patronage' means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association." Conversely, income that is directly related to the cooperative's activities is patronage sourced income.[19]

The directly related test first identifies the cooperative's activities with respect to marketing, purchasing, or services performed for patrons. "The same activities that may be directly related to the cooperative enterprise in one case may not be so directly related in another case."[20] For example, a workers' cooperative lease of a plywood plant for its own use is directly related to the cooperative's business.[21] Such a plant, however, may not be directly related to another cooperative's marketing, purchasing, or service activities. The activity meets the directly related test if it relates to business done with or for patrons.

The "actually facilitates" language is credited to Revenue Ruling 69-576.[22] This ruling concerned a cooperative that borrowed money from a Bank for Cooperatives to finance the acquisition of supplies for resale to its members. After the close of its fiscal year, the Bank determined its net margin and paid the borrower cooperative a patronage refund based on its ratable share of the bank's margin. In holding the patronage refund paid by the Bank was patronage sourced income to the borrower cooperative, the IRS said:

> The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative operations, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.[23]

The "actually facilitates" concept enunciated in Revenue Ruling 69-576 has been called the "touchstone or common thread" running through cases and rulings "which enables them to be reconciled" with the regulations, at times facially inconsistent.[24]

IRS letter rulings have permitted both supply and marketing cooperatives to treat income distributed from partnerships as patronage sourced. While not conclusive, this is a strong indication the IRS would reach a similar conclusion concerning distributions from an LLC.

On the supply side, the IRS looked at a cooperative that owned a plant that processed a raw material into a valuable agricultural input, which the cooperative then sold to its patrons. The cooperative formed a partnership with a non-cooperative corporation that was a reliable source of the raw material. The partnership acquired substantially all its raw material from the corporation and sold substantially all the processed farm input to the cooperative. The cooperative then resold substantially all of the input to its patrons.

IRS said the cooperative's distributive share of the partnership operating income attributable to product resold to the cooperative's patrons is patronage sourced and therefore eligible for the patronage refund deduction. IRS reasoned that this income is like a rebate on the cost of the product purchased for its patrons and is, therefore, "directly related to and facilitative of Coop's cooperative function of supplying (the product) to its patrons."[25]

On the marketing side, IRS reviewed an arrangement involving a marketing cooperative and a for-profit corporation. The cooperative furnished agricultural products grown by its members and the corporation processed them and marketed the resulting value-added items. The corporation paid the cooperative the current market value for the member product when delivered and an additional amount at the end of the year based on the corporation's earnings from selling the processed items. The cooperative loaned funds to the corporation to finance its operations in processing the product and realized interest income on the loans.

The IRS determined that the initial corporation payment to the cooperative for member products, the subsequent additional payment based on the corporation's earnings on the processed items, and the interest were all patronage-sourced income. When considering the additional year-end payment, IRS said it resulted from a contractual agreement between unrelated parties negotiated at arm's length. It found that neither the exact source of the funds paid to the cooperative nor the type of organizational arrangement between the parties is relevant. What the cooperative is being paid for is the only relevant issue. In this instance, it is being paid for the marketing of members' product, the sole function of the cooperative. Accordingly, the additional payment is from business done for its patrons and is patronage sourced.[26]

A key point for cooperatives forming LLCs that comes out of these rulings is the importance of making sure the operating agreement establishes a direct relationship between the LLC's activity and the cooperative's function on behalf of its membership. This can support the position that income or loss from the LLC is patronage sourced.

Why Isn't Everyone Using LLCs ?

If the LLC has so much to offer, why isn't every possible business changing to LLC status? There are good reasons not to rush into an LLC, or to choose another model.

While an LLC may sound good in the abstract, a limited body of administrative and judicial rulings exists to offer guidance when difficult questions concerning organization and operation arise (such as liability, governance, and member rights). When early users of LLCs have problems, they will bear the cost of being test cases to establish the detailed rules for conducting business as LLCs.

Several federal and state tax rules can add considerable complexity to forming an LLC. A state is not bound to follow the federal lead in granting favorable tax status to LLCs. A state may, for example, treat an LLC as a corporation for income or franchise tax purposes. If one or more LLC members is contributing appreciated property to the venture, allocating depreciation for tax purposes can be cumbersome. An LLC can have limited options in choosing its tax year (Sine 1996).

Other legal issues are not resolved in all states, and may be treated differently, at least in the short run, by different states. For example, an existing business may have entered into a contract forbidding it from assigning its rights and responsibilities to any other entity. States may take different attitudes toward whether converting an existing business to an LLC is an assignment of that contract to another entity, requiring the consent of the other parties to the agreement. Other administrative issues may arise, such as whether the time and money will have to be expended to retitle assets held by the existing business and whether transfer taxes will be due if ownership of the assets is transferred to a new LLC.

Some business consultants are calling the combination of state laws authorizing LLCs and the IRS "check the box" tax rules the most important developments in business formation since the advent of the general business corporation. Whether this becomes a fact will take many years to determine. But certainly the LLC is becoming a popular vehicle for organizing businesses. It will be both a tool of cooperatives and an alternative to the cooperative form of doing business. It offers both challenges and opportunities to rural residents and their advisers as they plan together to position rural businesses for prominent places in the twenty-first century.

Notes

1. Rev. Rul. 88-76, 1988-2 C.B. 360.
2. The author has intentionally not cited references to Virginia law in this paper. They are provided for illustrative purposes only. Anyone exploring the formation of an LLC needs to work closely with an attorney familiar with the LLC law in the state(s) where the LLC will be located and/or conduct business.
3. Treas. Reg. § 301.7701-1 to § 301.7701-3, *released as* Treas. Dec. 8697 (Dec. 17, 1996). This discussion applies only to businesses formed in the United States. The rules where a foreign firm is involved are more complex and beyond the scope of this paper.
4. Rev. Rul. 95-37, 1995-1 C.B. 130.
5. Capper-Volstead Act, 7 U.S.C. § 291.
6. "Associations, corporate or otherwise," are also covered by the section of the Cooperative Marketing Act of 1926 specifically authorizing sharing of market information (7 U.S.C. § 455) and the Fishermen's Collective Marketing Act, a Capper-Volstead clone covering commercial fishermen (15 U.S.C. § 521).
7. 7 U.S.C. § 291. Identical tests are set out in the Fishermen's Collective Marketing Act, 15 U.S.C. § 521.
8. Farm Credit Act of 1971, 12 U.S.C. § 2129(a).
9. The rate limitation at the time this article was written is 10 percent per year or the maximum percentage allowed by applicable state law, whichever is less. 12 C.F.R. § 613.3100(b)(iii)(B).
10. United States v. National Broiler Marketing Association, 436 U.S. 816 (1978).
11. 12 U.S.C. § 2129(a)(4).
12. 12 C.F.R. § 613.3100(a)(1).
13. *See also*, the Agricultural Marketing Act of 1929, which defines the term "cooperative association" as "any association in which farmers act together" to market their products and purchase farm supplies and services, provided it meets the mutuality of interest, one-member one-vote or limited return on equity, and majority member business standards (12 U.S.C. § 1141j).

This definition is incorporated by reference into the Agricultural Fair Practices Act, which protects producers from discrimination or coercion by handlers based on the producers' membership in a cooperative association. 7 U.S.C. § 2302(c).

14. I.R. Code § 1381(a)(2). Specific exceptions are provided for true tax-exempt organizations, mutual banks and insurance companies, and utility cooperatives.

15. Treas. Reg. § 1.1381-1(a).

16. Treas. Reg. § 301.7701-3(a).

17. An exception is access to the Federal Securities Act of 1933 exemption for farmer cooperatives with Internal Revenue Code § 521 status [15 U.S.C. § 77(a)(5)(i)]. This frees § 521 cooperatives from the act's registration and prospectus requirements covering the initial offering and sale of securities. Interest in this exemption is generally limited to cooperatives that issue transferable delivery rights that can fluctuate in value and/or investment-type financial instruments such as dividend-paying preferred stock, some or all of which is sold to non-members. Typical cooperative financial instruments—shares of common voting stock and patronage-based retains—that have a fixed value are not treated as securities under federal securities regulation.

18. I.R. Code §§ 701-761.

19. Rev. Rul. 74-160, 1974-1 C.B. 246; Rev. Rul. 75-228, 1975-1 C.B. 278; Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979).

20. Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 463 (1986).

21. Astoria Plywood Corp. v. United States, 1979-1 U.S.T.C. (CCH) ¶ 9197 (D. Ore. 1979).

22. Rev. Rul. 69-576, 1969-2 C.B. 166.

23. *Id.* at 167.

24. Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 452 (1986).

25. Priv. Ltr. Rul. 9033006 (May 14, 1990).

26. Tech. Adv. Mem. 9236001 (May 20, 1992). *See also*, Tech. Adv. Mem. 9211001 (Sept. 30, 1991).

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