

Cooperative Ownership Compared to Other Business Arrangements  
for Closely-Held Joint Ventures

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## INTRODUCTION

This research project was supported by funding from the Midwest Cooperative Education, Research and Extension Consortium. One purpose of the study was to evaluate the cooperative model versus alternative business structures for these closely-held joint ventures.

The strongest conclusion is that there is no single answer that will fit every situation. The best business structure, or combination of structures, depends on the particular situation. It is strongly recommended that families considering a joint venture consult competent legal and financial professionals before embarking on any joint venture.

## Five Business Structure Alternatives

Five separate business structure alternatives were considered. They were:

- partnerships,
- limited liability companies (LLCs),
- S corporations,
- C corporations, and
- cooperatives.

The table entitled “Comparison of Five Business Structure Alternatives for Closely-Held Joint Ventures” is presented as one of the main products of the research effort. It will be referred to in the section below that compares these different forms with respect to a number of business issues, including: ownership issues, start-up costs and capitalization, management and decision-making, flexibility in distributions, tax planning, estate planning, and stability over time. Preceding that discussion, the following brief descriptions of each business structure alternative are offered:

**Partnerships**, one of the oldest legal forms of closely-held joint ventures, involve two or more owners, at least one of whom is fully liable for the debts of the venture. The owners, called partners, may pull out at any time, usually without recognizing capital gain. Income is taxed at the partner level only.

**Limited liability companies (LLCs)** are a much newer innovation. In this case, owners are called “members”, and all members enjoy limited liability. These members may also pull out at anytime without triggering income tax on capital gains. And, like partnerships, income is taxed

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only at the member level. LLCs, therefore, much resemble partnerships, but, most importantly, they share the corporate characteristic of limited liability.

**S corporations** came along sometime before the LLCs, but they also offer a blend of partnership and corporate characteristics. Like a partnership, income may only be taxed at the owner (shareholder) level-- as long as certain ownership criteria are met. However, the S corporation resembles the C corporation and the cooperative in that distribution of appreciated assets to original contributors may trigger significant income tax on capital gains.

**C corporations** are similar to S corporations except for two significant differences. First, in a C corporation, income is generally taxed at both the shareholder and entity levels, a real disadvantage for income that is distributed. However, one advantage over the S corporation, LLC and partnership is that C corporations can deduct fringe benefits paid to employee-owners, who can exclude these benefits for tax purposes from their gross incomes. And, again, gains from distribution of appreciated assets may trigger significant tax liability--at both the shareholder and entity levels.

**Cooperative corporations** resemble partnerships and LLCs in that income may be taxed only at the individual (or member) level-- IF profits are distributed properly as "patronage refunds". Cooperatives share the corporate characteristic of limited liability and involve similar capital gains tax disadvantages. In the United States, the cooperative model was originally designed to offer farm families the chance to pool resources to meet common needs. This was achieved through a jointly-owned business that (a) distributed control equally (one member, one vote), (b) equitably distributed benefits on the basis of use (rather than on the basis of investment), and (c) equitably distributed capitalization responsibilities, also on the basis of use. Agricultural cooperatives typically require that members be active farmers.

## **Choosing a Business Structure-- Six Issues**

This section will go step-by-step through the attached table entitled "Comparison of Five Business Structure Alternatives for Closely-Held Joint Ventures". Neither the attached table nor the accompanying text below is presented as the full and final answer to any of the issues raised. Rather, this report represents a general discussion of closely-held joint ventures in light of the advantages and disadvantages that each structure offers.

### *(1) Ownership Issues*

The phrase "closely-held joint venture" means that the number of owners involved is rather small, generally three to five families. The only business structure alternative that involves an upper limit on the number of owners is the S corporation. The S corporate limit to a maximum of 75 shareholders, however, should not affect a joint venture of three to five families. S corporations also may not have other corporations as owners or shareholders. While this may limit the option of a multiple-entity, or multiple-model structure, it need not be an issue.

The cooperative structure, as authorized under the federal Capper-Volstead Act as well as state cooperative laws, places limitations on the return on investment. This limitation is 8%.

Such limitations could affect joint ventures that wanted to attract significant investment from non-farmers in the community, in which case the cooperative model may be at a disadvantage. At the same time, families that did want to limit ownership to farm families could probably enforce that limitation through by-laws or operating agreements written into any of the five models of ownership.

One ownership issue that is much more significant involves owner liability. The major disadvantage of a partnership over any of the other models is that at least one partner in a partnership must be fully liable for the debts and other obligations of the business. The LLC differs from the partnership on this one crucial issue, in that all members of an LLC, like all corporate shareholders and cooperative members, enjoy the advantage of limited liability. The disadvantage that this represents for the partnership is probably enough to exclude it from consideration altogether. Therefore, the remaining comparisons will focus more on the LLC and its three corporate alternatives.<sup>2</sup>

## *(2) Getting Started*

There are at least two issues surrounding the task of getting a joint venture farm business off the ground. One involves having access to qualified outside assistance. The cost of the assistance will reflect the complexity of the proposed ownership structure. The degree to which available legal, financial, and other business development experts are familiar with the proposed structure will also affect the cost and availability of assistance.

The partnership and C corporation, and to a lesser extent the S corporation, have all been around long enough, and have been used widely enough, so that advice on their use is readily available. There are also many cooperative specialists that can offer help with that model. The LLC has been around the shortest time, and therefore is not so familiar to either farmers or their advocates. However, the LLC, like the older partnership model, is a relatively simple structure to construct or establish. It involves certain rules that must be followed, but not the annual regulatory reporting, nor the formal board structure of the three corporate models.

However, it must be realized that any business that is started by more than one family, especially unrelated families, is going to require thoughtful consideration of legal and financial matters. The partnership and LLC may seem deceptively simple on the surface, but certain issues, like tax and estate planning, require a long-term vision and the appropriate rules to achieve that vision. But because the LLC will usually involve less total administrative cost, over time, and because more and more professionals are becoming familiar with this alternative, it would seem to offer a significant advantage for closely-held joint ventures in which administrative costs cannot be widely spread.

A second challenge to starting a joint venture farm business is coming up with the necessary capital. Ultimately, this will depend on the solvency of the participating farms, the

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<sup>2</sup> It should be noted that cooperatives are corporations. They must be formally incorporated under state statutes, and, like other corporate models, they involve the formal structure of corporate boards elected by the corporation's owners. However, there are significant differences between cooperatives and other corporations, as will be discussed further.

cost and availability of debt capital, and the feasibility of the business plan. However, each of the business models involve various rules that could affect capitalization efforts.

Again, because the partnership model requires that all owners participating in management share liability for the business' obligations, the LCC has a significant comparative advantage. In other words, an LLC might attract more investors than a partnership because every investor may enjoy limited liability. Limited liability is also available in the three corporate alternatives.

Investment in the form of the contribution of appreciable assets may be discouraged in the three corporate models because of tax liabilities incurred if and when those assets are ever withdrawn. That alone should not eliminate the corporate option, because appreciable assets may best be kept out of joint ownership anyway, and rented to the joint venture instead. Cooperatives may also limit capitalization options if ownership is restricted to active farmers, and cooperatives also involve an 8% limit on dividends paid to capital.

Recent changes in IRS regulations eliminate the requirement that an LLC have no more than two of the four corporate characteristics if it is to be taxed as a partnership. Consequently, the founders of an LLC can make ownership interests freely transferable without risking the loss of being taxed like a partnership.

In summary, then, there will be legal and consultation costs regardless of the model chosen. The more complex the ownership structure, the higher the start-up costs, regardless of the model chosen. The LLC may have an advantage over the long-run with lower administrative costs for a closely-held joint venture. Furthermore, because all three corporate models discourage investment in the form of contribution of appreciable assets; because cooperative limits on payment to capital may discourage outside investment; and because transferability may be equally limited under any of the models, it would appear that the LCC has an overall advantage regarding these various issues involved in getting the business off the ground.

### *(3) Decision-Making and Management*

The issues of decision-making and management are essentially issues of "control", and the different models vary in how they distribute this control. A cooperative is unique in that, typically, every member receives one (and only one) vote to elect a governing board of directors, and no one member or director may veto the decision of the majority (as may be the case in a partnership or LLC). S and C corporations and the LLC model, on the other hand, allocate voting rights in proportion to investment. Unlike any of the three corporate models, most LLCs do require unanimous consent of members on many important issues, and members do not usually hand over control to a representative. Like the cooperative, the S and C corporations do require a board of directors, and under all three corporate forms the board may hire a manager to run the day-to-day affairs of the business. The LLC may also institute centralized management, especially since recent IRS rule changes allow all four corporate characteristics.

Whether or not these differences are advantages or disadvantages will depend upon the goals and philosophies of the owners, and upon the particular situation. For instance, the

formality of a corporate board may entail excessive administration costs in a closely-held joint venture, while some owners may accept these costs and prefer to hand over decisions to a representative governing board.

While each corporate alternative does require a board of directors, and while the cooperative model generally does require one member-one vote, many of the rules regarding control are flexible under each of the different models. Any of the forms may institute one member-one vote, if owners prefer equal distribution of control. And, as stated above, the LLC may also centralize its decision-making, and it may do so without losing its partnership tax status. Therefore, current distinctions regarding “member-managed” or “manager-managed” LLCs may not be as consequential, at least in terms of income taxation.

In most cases of joint venture farm businesses, every owner would probably want to participate in every major decision. And while day-to-day management tasks might be distributed according to the owners’ various skills, this could probably be done without the need for centralized control. In other words, in a closely-held joint venture, the less formal control structure of an LLC may be preferable to the administration costs associated with the formal corporate board structure.

However, there is another issue of control that offers no simple conclusions. It is not clear whether one model surpasses another regarding the complex matter of “control across generations”. In other words, it is not clear which model, if any, could best assure current owners that their descendants will maintain an appropriate stake and voice in matters of the joint venture in the unforeseen future. This issue may be less critical if each family keeps appreciable assets like land under family ownership, but equity that is invested in the joint venture will raise issues of future control and ownership. This topic of future control will be dealt with more thoroughly under the heading of “Adjusting to Change” below.

In summary, because of the flexibility of each of the models regarding issues of present-time decision-making and management, it would seem none have a great advantage over the other in this regard. However, in a closely-held joint venture in which every owner wants to participate in management, the choice of appropriate business structure may tip in the direction of the LLC because of its lower administrative costs and flexibility.

#### *(4) Flexibility in Distributions*

To the extent that all of the capital investors in a joint venture invest corresponding levels of labor throughout each year, flexibility in distributions may simply be required for tax planning. For instance, in a joint venture organized as a C corporation, income may be distributed to employee-owners as salaries and fringe benefits rather than as dividends in order to enjoy tax deductions and to avoid a “double tax” on profits. These and other tax issues will be discussed in the next section, but it may be said now that flexibility in distributions, for tax purposes, may best be achieved with a combination of the various business structure models.

It is probably more likely that capital investment will not correspond directly with labor contributions, and this raises another need for flexibility in distributions. When all owners contribute equal levels of capital and labor, it may be irrelevant whether income from the joint

venture is distributed as dividends or as salaries. But when one owner-- perhaps an elderly family member-- has invested years of savings but can contribute little in labor (while for other owners the reverse is true), flexibility would be needed to fairly "reward" the varying contributions of capital and labor.

Let it first be said that all of the business structure models are fairly flexible with regard to distributions. Consider the cooperative model. Cooperatives typically favor reward to "use" over reward to capital. In one of the dairy cases studied, the families considered measuring "use" in terms of labor contributed, and in this sense, the farm would have been creatively organized as a "worker cooperative". Profits from the joint venture were to be distributed in proportion to labor contributed each year.

If there was a member of the cooperative that contributed more capital than labor, the membership as a whole would still have the flexibility to compensate that member. Cooperative law does allow payment of dividends to capital investors-- although such dividends are usually limited to 8%. Beyond that, the cooperative model also retains other distribution options that would be available under any of the business structure models. For instance, if owners either lease their land or make loans to the joint venture, they may be "rewarded" with rent and interest payments. In other words, income from the joint venture may be distributed to labor as salaries after capital investors are compensated in any of a variety of ways.

The freedom to distribute income either in the form of salaries and fringe benefits, as dividends, as rent, and/or as interest payments is available, in varying degrees, in each of the business structure alternatives. The cooperative's 8% limit on dividends may not be significant if that rate is enough to satisfy all involved. With S corporations, the IRS limits the temptation to minimize salaries (and associated employment taxes) and maximize dividends (which are not taxed at the corporate level). This IRS limitation, together with the limitation to a single class of stock, would probably make the S corporations the least flexible of the models. C corporations are also somewhat limited, in that advantageous tax deductions for fringe benefits are offset by double taxation on income. The LLC is probably the most flexible model. However, each of the limitations above may often be side-stepped with creative distributions in the form of rent and interest payments.

#### *(5) Tax Issues*

It would seem that the greatest efforts are typically put into devising a business structure that minimizes the tax burden. Taxation of two types of income is most relevant—ordinary income and capital gains. Regarding ordinary income, each of the models except the C corporation may avoid taxation at the entity level. The other models may pass the tax along to the individual owners, while under the C corporation both the individuals and the corporation must pay taxes on income. This may be a significant disadvantage for the C corporation for income that is distributed as dividends.

However, the C corporation and the cooperative have the ability to deduct its employee-owners' fringe benefits. On the other hand, partnerships, LLCs, and S corporations are not considered separate employers from their owners, which is probably related to the advantageous ruling that these models need only be taxed at the individual level. But the trade-

off here is that these employee-owners must pay for their own fringe benefits without deductions. One interesting question is whether a cooperative could enjoy both single taxation and deductions for fringe benefits. While cooperatives typically enjoy both types of tax deductions, if it is structured as a “worker cooperative” perhaps employee-owners would be required to pay their own fringe benefits and forego the entity level deductions.

The deductions for fringe benefits, available to the C corporation, might be achieved without significant double taxation if creative distributions and accounting can minimize the income of the corporation. However, very significant income tax on capital gains may be incurred if appreciable assets are put into any of the three corporate models. Unless owners can be assured that such assets will not be distributed for a very long time-- and it is difficult to be so assured-- it is generally recommended that assets such as land not be contributed to a joint venture organized as a closely-held corporation.

A related issue involves “conversion costs”. Land that has appreciated in value and is currently owned under a family corporation may involve serious income taxes on capital gains if it is removed from that corporation for contribution to the joint venture. It would generally be better to keep the land in family ownership and rent it to the joint venture. If any land or other appreciable assets are to be contributed to the joint venture, it would be better to put them in an LLC rather than a corporate structure, in order to avoid future tax liability. Besides tax advantages on capital gains, the LLC, like the partnership, enjoys “favorable adjustments in the basis of its assets” when ownership interests are sold.<sup>3</sup> None of the corporate models enjoy this favorable adjustment.

Of the trade-off between LLC income tax advantages on capital gains, and C corporation fringe benefits tax deduction advantages, it would seem the former is of greater significance. As long as the joint venture is going to involve appreciable assets, it seems critical that they be kept out of corporate ownership, and either placed in an LLC or kept in private ownership to be rented to the joint venture. If no appreciable assets are to be contributed to the joint venture, a C corporation may be chosen, with its accompanying income tax deductions.

To complicate matters, it has often been written that a “multiple-entity model” may often provide the best means of gaining the advantages of both the LLC and the C corporation. Appreciable assets may be jointly-owned in the LLC, which would then rent those assets to a jointly-owned C corporation, which itself could cover the employee-owners’ fringe benefits. It has also been said that, given this option, many families choose to forego the advantages of the C corporation’s deductions and, for simplicity’s sake, institute the LLC model alone. Again, the more complex the ownership structure, the higher the start-up costs regarding time spent and legal assistance.

## *(6) Adjusting to Change*

Minimizing the tax burden may be the most common concern of those trying to establish a closely-held joint venture. However, what should be considered just as carefully is how the

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<sup>3</sup> I.R.C. § 754 allows the LLC/partnership to increase its basis in its assets for purposes of calculating depreciation and gain or loss for a new member/partner. This increase allows the new member /partner to report larger depreciation deductions and/or less gain when assets are sold.

business will endure inevitable change. Each family's estate planning should be considered when formulating a collective strategy for bringing subsequent generations into the business. Furthermore, death, divorce, and irresolvable disagreements are three events that could bring about an unexpected early withdrawal of one or more owners. Critical questions that families must carefully consider include:

- Who should be allowed to hold ownership interests in the joint venture in future generations? (An issue of ownership.)
- How will decision-making authority be allocated among original and subsequent owners? Among farming and non-farming owners? Among greater and lesser invested owners? (An issue of control.)
- How will income be distributed when, over the generations, ownership becomes dispersed among a widening circle of individuals, with varying levels of investment and involvement in the joint venture? (An issue of distribution.)
- How can remaining owners adjust to the unexpected early withdrawal of an owner due to death, divorce, or disagreement? In other words, how will equity be distributed to disassociating owners and/or heirs without forcing dissolution of the joint venture? (An issue of stability.)

There are some differences in the five business structure alternatives that could be important to answering these questions, but the differences are of limited relevance. However the families choose to answer the questions above, there are generally rules and agreements that can be enforced under any of the five business structures.

If the families choose to restrict ownership and control to active farmers, they may write that requirement into agreements or by-laws under any business structure. Agricultural cooperatives typically do restrict membership to active farmers. The S corporation limit to 75 shareholders, and its exclusion from ownership by corporations and non-resident aliens, may or may not be an issue.

If the families want control in the future to be distributed equally ("one member, one vote"), they can do so under any of the models. If they want to distribute future control in proportion to investment, conversely, then cooperative law in some states may prohibit that.

Regarding distribution of income in the future, it has already been said that all of the models are fairly flexible. The LLC and partnership are more flexible than the corporate alternatives. However, all of the models may use rent and interest payments to reward its owners, and these approaches may provide adequate flexibility in distributions in the present and in the future.

These issues of ownership, control, and distribution are almost always more complicated in a joint venture business-- as compared to a single family proprietorship-- and things become even more complicated when trying to plan for the unknown future. What if the children of only one of four original families wants to continue farming in the business? Should the children of

the other families be given a voice in how the farm is managed in the future? Should they continue to receive income from the business? Fortunately, each of the five business structure alternatives are, for the most part, flexible enough to accommodate answers to these difficult questions-- if and when the answers are determined.

A final issue involves the stability of the joint venture for remaining owners when another owner either dies, divorces, or chooses to withdraw from the business for whatever reason. In any of these cases, early or unexpected withdrawal of assets could force the liquidation of the entity, perhaps much to the dismay of remaining owners. Fortunately, there are many precautions that can be made to help avoid unwanted liquidation.

The choice of business structure has limited relevance to this issue of stability. What is relevant is the extent to which owners may withdraw assets from the joint venture. In a corporation, majority interests may refuse to allow minority owners to withdraw their assets, while in an LLC any owner may withdraw his or her assets at will-- often without recognizing capital gains. However, while majority control over withdrawal of assets in a corporation may provide certain stability for that majority, there are better ways to deal with this issue.

One strategy that is available under any of the business structures is to put together buy-sell agreements at the start of the new joint venture-- while general consensus still prevails. Buy-sell agreements should establish (a) the purchase price of ownership interests (which may be adjusted as appropriate at annual meetings) and (b) the appropriate time intervals for installment purchases. These agreements may be written so as to discourage early withdrawal of ownership interests.

In addition, owners may also want to purchase life insurance policies to cover the death of other owners. This may be quite costly, but it could be worth it in the event of a tragedy. Finally, the cooperative sector has developed equity revolvment strategies that could probably be instituted under any business arrangement. One example is the "base capital plan", which also provides an innovative capitalization strategy. Equity revolvment strategies plan for the return of equity to retired owners and heirs over a time period that balances their needs with those of the remaining owners in the joint venture.

Perhaps the best way to avoid instability in the event of an owner's disassociation is to keep appreciable assets out of the joint venture altogether. For instance, if dairy facilities under joint ownership are fully depreciated in ten years, then after that time there will be less of value for an heir to inherit, and it will be easier for remaining owners to buy out a disgruntled fellow investor. So while tax considerations argued for keeping appreciable assets out of corporate ownership, this issue of stability argues for keeping joint ownership of appreciable assets to a minimum under any business structure. To the extent that it is done, buy-sell agreements may discourage early withdrawal by an owner, while life insurance policies and equity revolvment strategies may provide additional security for remaining owners.

## **Conclusions and Questions**

This comparison of five alternatives-- the partnership, the limited liability company, the S corporation, the C corporation, and the cooperative-- concludes that the LLC offers the most advantages. Lower administration costs, limited liability, flexibility in distributions, single taxation of income, capital gains tax benefits, and favorable adjustments in the basis in assets are among the reasons why the LLC may often be the best choice of business structure for a closely-held joint venture.

The partnership, which is similar in many respects to the LLC, was ruled out simply because it did not offer limited liability to all owners. In a closely-held joint venture, "cooperative principles" of equal control, equitable distributions, and equitable capitalization can probably be accomplished in any carefully structured model-- through by-laws, operating agreements, or more informal means.

However, things become more complicated if appreciable assets are already in corporate ownership, because of conversion costs associated with liquidating a corporation. C corporations and cooperatives also have the advantage of tax deductions for fringe benefits paid to employee-owners. Conversion costs and fringe benefit deductions may be reason enough to develop a "multiple entity model" that includes both an LLC and a corporation. The best choice for that corporate structure may be the S corporation, the C corporation, or perhaps even the cooperative, depending upon the situation.

The S corporation may be used to postpone taxation on built-in gains when transitioning from a C corporation to an eventual LLC. More often, a C corporation would be better in a multiple entity model because of its deductions for fringe benefits paid to employee-owners. It is not clear whether the cooperative could be used in place of the C corporation in this multiple-entity model in order to get both deductions for fringe and single taxation of income that is returned as patronage refunds. This would be a question for the IRS.

While these options should be considered, many families may choose to forego a multiple entity model (and associated deductions for fringe benefits) and simply select an LLC in order to keep things simple. Even if an LLC is chosen, it is probably best to keep appreciable assets out of joint ownership in order to avoid unforeseen conflicts in the future. In order to ensure stability of the joint venture and deal with unexpected early withdrawals by an owner, it is highly advised that buy-sell agreements be put into writing at the outset, while there is still general consensus among the families.

It must be said that all of the conclusions offered in this report would benefit from a careful review by colleagues in academia, by legal and financial professionals, and, most importantly, by farm families themselves. Any conclusions regarding the comparison of business structure models should be taken as the researchers best interpretations of some very complicated laws. Any family considering a closely-held joint venture is strongly encouraged to seek out additional legal and financial assistance. There is no single "correct" approach that can be applied across every situation.

While the cooperative business form, by itself, may not be the best way to organize a joint venture farm business, in the cases studied, there was an underlying "spirit of cooperation" that was perhaps the most encouraging discovery of this research project. This cooperative

spirit is probably essential if farm families are going to overcome the challenges facing their industry. Further research would help direct this cooperative spirit along paths of rationale business planning, particularly with respect to issues of scale, capitalization, and tax planning, as well as the related business structure issues presented in this report.