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Virginia Business Legal Structures

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Introduction

As a great place to do business, Virginia enjoys top rankings nationally.[1] Among reasons to do business in Virginia is the strength of its business entity laws that provide robust liability protection for managers, directors and officers of Virginia businesses. Liability protection is one of the key drivers in forming a business, but other considerations are also important, including tax treatment, the ease with which an entity can raise capital, and the legal formalities involved in governing the business. All of these bear on the question, "What form of business should I choose? An LLC? An S corporation? A cooperative?"

As important as choosing the right type of legal structure is the need for a solid business plan. When more than one founder is involved, crafting a business plan that expresses the group's shared goals is vital. Bringing all of this together – the right legal structure, a strong business plan, appropriate goals and roles of each person within the working group – can be challenging. Third-party consultants and professionals experienced in start-up ventures can provide the needed roadmap for this process. The Virginia Foundation for Agriculture, Innovation and Rural Sustainability (Virginia FAIRS) routinely helps new businesses navigate the start-up process and is a resource to ag-based business ventures in Virginia.

In that vein, Virginia FAIRS has provided this guide to introduce the types of business structures and entities available in Virginia. Choosing the right business entity can be a complex analysis, dependant on the unique facts associated with the new venture. Founder(s) are strongly advised to seek the advice of an attorney and accountant who are knowledgeable and experienced in helping start-up ventures get started on the right foot.

This article does not constitute legal advice and must not be used as a substitute for the advice of a qualified attorney.

Business Structure Summary

When a group decides to go into business together, they combine their money, skills, knowledge and other resources. These resources are pooled via a business structure or entity, including:

Partnerships
A partnership is an association of two or more persons to carry on as co-owners a business for profit. Each partner contributes money, property, and/or services, and agrees to share in the profits or losses of the business. Partnerships are "pass-through" entities for tax purposes, meaning profits pass through to the individual partners and are taxed at the individual level only. From a liability point of view, if the partnership is a general partnership, each partner is

[1] *Forbes* annual survey for "best states for business" ranked Virginia second in 2010 and first for the prior four consecutive years; CNBC named Virginia its "Top State for Business" in 2009 and 2007.

at risk for the partnership's obligations. For this reason, partnerships are often formed as "limited partnerships" so that liability can be limited for some (but not all) of the partners.

Limited Liability Companies

A limited liability company (an "LLC") is a hybrid entity, combining the tax characteristics of a partnership (assuming there is more than one owner) with the limited liability characteristics of a corporation. Like a partnership, an LLC is a "pass-through" entity for tax purposes: the LLC is not taxed on its profits; rather, the owners of the LLC are taxed. For liability purposes, LLCs are like corporations because the owners' personal assets are not exposed to the risks of the business, as is the case for general partnerships. Because of this "best-of-both-worlds" profile, LLCs are a very popular form of entity.

Corporations

Corporations are the most common form of organization for big business in the United States. Ford Motor Company and General Electric Company are examples of corporations. Corporations can also be small – as small as a single stockholder – but, no matter the size, a corporation has an identity that is separate from the identity of its stockholder(s). As such, a corporation provides its stockholders with protection from the liability associated with the corporation's business and activities. While the value of the stockholder's investment in the corporation - i.e., his stock value – is exposed to the risks of the corporation's business, typically those risks do not reach beyond the stockholder's investment in the stock.

Upon incorporation, a corporation is a separate taxpayer and, as such, it pays corporate tax on the profits of the corporation's business. When those profits are distributed to stockholders in the form of dividends, the stockholders pay income tax on those dividends. To avoid this so-called "double tax," many small business corporations elect to be taxed under Subchapter S of the Internal Revenue Code, thus becoming an "S corporation." An S corporation is a "pass-through" entity, meaning it does not pay taxes at the entity level; rather, the S corporation stockholders pay the tax associated with the corporation's profits. In the absence of the S election, the corporation remains a "C corporation" and, as such, a separate taxpayer. Big corporations cannot elect to become an S corporation.

Cooperatives

A cooperative is a corporation that conducts its business "on a cooperative basis." Generally, this means that the economic participation in a cooperative is based on the amount one patronizes the business of the cooperative, not on the size of one's investment in the cooperative (i.e., the amount of stock held). Members of a cooperative – who are generally the bulk of the cooperative's patrons – enjoy the same limited liability protection as stockholders of a corporation. They are taxed on the basis of their patronage income, and the cooperative itself typically does not pay taxes. Cooperatives are a more complicated legal structure compared to partnerships, LLCs, or corporations, but, in certain circumstances, they are an appropriate choice.

Certain states have "New Generation Cooperatives" which make it easier to reward, and thus attract, outside investors to the cooperative. Virginia does not have this form of cooperative.

Choice of Entity Comparative Chart

	Partnerships	LLCs	Corporations	Agricultural Cooperatives
Formation	**General partnership:** no documentation required **Limited partnership:** Certificate of Partnership ($100)	Articles of Organization ($100)	Articles of Incorporation ($75)	Articles of Incorporation ($75)
Annual Fees	**General partnership:** $0 **Limited partnership:** $50	$50	$100	$100
Limited Liability for Owners	**General partnership:** no **Limited partnership:** yes, for limited partners	Yes	Yes	Yes
Taxation	Pass through entity – owners are taxed, not the entity. Pass through of taxable income to owners cannot be delayed. Partnerships file informational returns on Form 1065.	Pass through entity – owners are taxed, not the entity. Pass through of taxable income to owners cannot be delayed. LLCs file informational returns on Form 1065.	**C corporations:** corporation pays corporate tax and stockholders pay income tax on dividends (so-called "double tax") **S corporations:** Pass through entity – owners are taxed, not the entity. Pass through of taxable income to owners cannot be delayed. S corporations file tax returns on Form 1120S.	For tax-exempt cooperatives, the cooperative is generally treated as a pass-through entity – owners are taxed, not the entity. Non-exempt cooperatives may have tax at corporate level. Pass through of taxable income to members can be delayed by using nonqualified allocations. Cooperatives file tax returns on Form 1120-C.

	Partnerships	LLCs	Corporations	Agricultural Cooperatives
Transferability of Interests	Partnership interests are freely transferable unless limited by agreement (typically called a Partnership Agreement)	Membership interests are freely transferable unless limited by agreement (typically called an Operating Agreement)	Stock is freely transferable unless limited by agreement (typically called a Stockholders Agreement)	Stock is freely transferable unless limited, typically by the cooperative's bylaws
Securities	Yes, partnership interests are securities	Yes, membership interests are securities	Yes, stocks are securities	Yes, stocks are securities; special exemptions available
Governing Documents	No statutory requirement but partnership agreement advisable	Must have at least "short form" operating agreement; if more than one owner, should have full operating agreement	Must observe more formalities than the LLC, including having bylaws and annual meetings. If more than one owner, should have stockholders agreement.	The governance and economic "rules" of a cooperative are typically set forth in the cooperative's bylaws and its contract with member-patrons
Management	**General partnership:** managed by one or more general partner(s) **Limited partnership:** managed by general partner. Partner voting is typically based on percent ownership in the partnership.	May be managed by one or more managers or members. Member voting is typically based on percent ownership in the LLC.	Must have a board of directors and officers. Stockholder voting (including the election of the board) is based on how many shares of stock the stockholder holds.	Must have a board of directors (at least one of whom must be a public director) and officers. Member voting (including the election of the board) is per capita – one vote per member – not on percent ownership in the cooperative.
Owners	Anyone (referred to as partners)	Anyone (referred to as members)	For S corporations, only US residents and natural persons. Limit 100. Referred to as stockholders.	Agricultural producers, typically referred to as members. Non-ag producers may invest, but they cannot vote.

	Partnerships	LLCs	Corporations	Agricultural Cooperatives
Classes of Ownership	Very flexible – may create a variety of classes of ownership	Very flexible – may create a variety of classes of ownership	For S corporations, may not have more than one class of stock (but non-voting stock doesn't count as a second class)	May have more than one class of stock, but only common stock may vote (common stockholders are the members, as above)
Tax Treatment of Annual Earnings	All distributions to an active owner who is an individual must be treated as self-employment income (reported on a K-1). Typically, this means general partners must pay self-employment income.	All distributions to an active owner who is an individual must be treated as self-employment income (reported on a K-1)	Opportunity to classify payments to an owner who is an individual as salary (reported on W-2) or general corporate earnings not subject to employment taxes (reported on K-1). This presents slight tax advantage over LLC.	All qualified distributions to members who are individuals must be treated as farm income (reported on a 1099-PATR)
Incentive stock options, ESOPS	No	No	Yes	No
Fiduciary Liability	**General partnership:** managing partners are fiduciaries **Limited partnership:** general partners are fiduciaries	Yes, managers are fiduciaries	Yes, directors and officers are fiduciaries	Yes, directors and officers are fiduciaries

	Partnerships	LLCs	Corporations	Agricultural Cooperatives
Capitalization	No limit on investments	No limit on investment	No limit on investment	Only agricultural producers may be common stockholders. Non-ag producers may invest but dividends are limited to 8%. Cooperatives are generally better candidates than other entities for grant funding.

Partnerships

Introduction

Virginia state law defines a partnership as the association of two or more persons to carry on as co-owners a business for profit. A business carried out by only one person in his individual capacity is a sole proprietorship. But the addition of another co-owner to the business makes the enterprise a partnership. This is true even if persons have not intended to form a partnership. Thus, many "inadvertent partnerships" exist as a matter of law. Federal tax law analyzes partnerships differently, sometimes finding a partnership for tax purposes – for example, in the area of joint ventures – when one does not exist as a matter of state law.

Virginia has two types of partnership: a general partnership and a limited partnership. A general partnership exists whenever the definition, above, is satisfied. Nothing needs to be filed with the Virginia State Corporation Commission, nor does a partnership agreement need to be executed, though a well-drafted partnership is highly recommended. Partners in a general partnership are liable for the obligations of the general partnership. There is no legal barrier between their personal resources and the partnership's business. For this reason, many persons who wish to conduct business as a partnership choose to become a limited partnership (or, more often, a limited liability company, discussed below). In a limited partnership, one or more partners may be a "limited partner." By statute, a limited partner is not liable for the obligations of the limited partnership unless he participates in the control of the business and does not make it clear to persons he is dealing with that he is a limited partner. Even in limited partnerships, at least one partner must be a general partner and thus be liable for the obligations of the partnership. Often this risk is mitigated by having the general partner be a corporation or other entity formed solely for the purpose of serving as the general partner.

Because general partnerships do not afford limited liability protection for their owners, they are typically not recommended as way to conduct business. Indeed, as noted above, general partnerships usually exist by default rather than intention. Limited partnerships offer limited liability to the limited partners, but not the general partner. Limited partnerships are thus recommended over general partnerships, but they remain a distant second to limited liability companies.

How Organized?

A limited partnership is formed when a Certificate of Limited Partnership is accepted for filing with the Virginia State Corporation Commission (the "SCC"). A Certificate of Limited Partnership may be completed and filed by accessing that form, and following the filing instructions, available on the SCC's website. The general partner(s) must sign the Certificate. The initial filing fee for a limited partnership is $100. The SCC charges an annual fee of $50 for the privilege of remaining a Virginia limited partnership year to year. If the fee is not paid, the limited partnership will be automatically terminated and cease to exist.

Before a partnership commences business, it should file a Form SS-4 to obtain a separate employer identification number (EIN) for the limited partnership. This is a simple on-line filing. See http://www.irs.gov/businesses/small/article/0,,id=102767,00.html or Google "Apply for EIN online" and choose the IRS search result. The EIN is assigned within minutes of the online application. An EIN is usually required in order to open a bank account for the partnership.

How Operated?

Partnerships are well advised to execute a partnership agreement to address how the partnership is governed, how the partnership's profits and losses are shared, and how partners may exit the partnership. In the absence of an agreement, the Virginia Uniform Partnership Act, the Virginia Revised Uniform Limited Partnership Act and federal partnership tax law will determine the economic, management, transfer-of-ownership, and tax rules for the partnership, which may or may not match the partners' expectations. While some of these rules cannot be altered by agreement, many can, which is why a well-drafted partnership agreement is recommended.

Partnerships are "pass-through" entities for tax purposes, which mean the partners, and not the partnership itself, are the taxpayers. Although the partnership does not pay taxes, it must file an annual information return on Form 1065 showing its income, deductions and other required information. The partnership must furnish each partner copies of Schedule K-l to Form 1065. Each partner's K-1 lists his share of the partnership's income, deductions, credits, etc. It also provides guidance as to where each partner should report each item on his own tax return (Form 1040). K-1s includes the partner's "capital account," which is a concept in partnership tax law similar, but not identical, to one's basis in an asset.

Limited Liability Companies

Introduction

A Virginia limited liability company (an "LLC") is a hybrid entity, combining the tax characteristics of a partnership (assuming there is more than one owner) with the limited liability characteristics of a corporation. Like a partnership, an LLC is a "pass-through" entity for tax purposes, which means the LLC is not taxed on its profits; rather, the owners (called "members") of the LLC are taxed. This avoids a double layer of taxation that exists for corporations, discussed later in this guide. For LLCs that have only one member, the LLC is "disregarded" for tax purposes, meaning the sole owner is responsible for all taxes on the LLC's profits. Losses likewise pass through the LLC to its owner(s). Unlike partnerships, for liability purposes, LLCs are not "pass-through" entities. LLCs offer limited liability protection to their owners and, in this way, are like corporations. While an LLC member's investment in the LLC is exposed to the risks of the LLC's business and activities (in the same way a stockholder's investment in a corporation is exposed), typically those risks do not reach beyond the member's investment to his other, personal assets.

How Organized?

An LLC is formed when Articles of Organization are filed with the SCC and the SCC issues a Certificate of Organization – essentially, the LLC's birth certificate. Articles of Organization may be completed and filed by anyone by accessing that form, and following the filing instructions, available on the SCC's website. The initial filing fee for an LLC is $100. The SCC charges an annual fee of $50 for the privilege of remaining a Virginia LLC year to year. If the fee is not paid, the LLC will be automatically terminated and cease to exist.

The only other statutorily required document for an LLC is a written statement of the following: (i) each member's name and amount or agreed value of his capital contribution, (ii) the circumstances under which a member may be required to make additional contributions; (iii) the right of a member to receive distributions, including a return of all or part of the member's capital contribution; and (iv) the circumstances under which the LLC will be dissolved. This statement is sometimes referred to as a "statement in lieu of operating agreement" or a "short form operating agreement." This document is best prepared by an attorney, and the self-help filer of the Articles of Organization, as above, will often overlook this statutory requirement to the later dismay of the members. Virginia law also requires the following items to be maintained at the LLC's principal office: (i) a current list of the full name and address of each member, in alphabetical order; (ii) the LLC's Articles of Organization and the Certificate of Organization; (iii) copies of the LLC's federal and Virginia tax returns for the three most recent years; and (iv) the LLC's operating agreement (or statement in lieu of operating agreement, as just described).

Before the LLC commences business, it should file a Form SS-4 to obtain a separate employer identification number (EIN) for the LLC. This is a simple on-line filing. See http://www.irs.gov/businesses/small/article/0,,id=102767,00.html or Google "Apply for EIN online" and choose the IRS search result. The EIN is assigned within minutes of the online application. An EIN is required in order to open a bank account for the LLC.

How Operated?

If the LLC has more than one member, the LLC members are well-advised to execute an operating agreement (essentially, an owners' agreement), which should address, among other things:

- How the LLC will be governed, i.e., by all the members or by one or more managers? Will managers have unlimited authority or will members have a vote on material decisions? How will successor managers be appointed?

- How the profits will be divided, i.e., if one member is contributing cash and the other services, will profits first be used to pay back the member contributing the cash or to pay some kind of priority return on that investment?

- How/when a member may exit the LLC, i.e., what happens upon the death of a member, or an active member ceasing to be involved with the business, or when a member wants to sell out? Absent an operating agreement, LLC members are free to transfer their

ownership in the LLC at any time to any person, an event that would give the remaining owner(s) a new business partner, like it or not.

Operating agreements are very important for LLCs because they articulate the economic, management, and transfer-of-ownership expectations of the LLC members. The ability of LLC members to do this – in large measure, to write their own rules – is one of the key advantages of the LLC. But this flexibility can become a major liability when the members have either not entered into an operating agreement or have entered into an operating agreement that does not describe what the members actually wanted. LLCs have only been in existence since 1977 when Wyoming passed the first LLC act in the United States. Because of this, the body of LLC law is not as well developed as corporate law. Thus, if members have to resort to litigation to resolve disputes, the results can be more variable and unexpected. Again, this risk can be mitigated by a good operating agreement.

Although an LLC does not pay taxes at the entity level, it must file an annual information return on Form 1065 showing its income, deductions and other required information. An LLC's tax year must be a calendar year. The return is due April 15, which can be extended by filing Form 8736. The LLC must furnish each member copies of Schedule K-l to Form 1065, also by April 15. Each member's K-1 lists his share of the LLC's income, deductions, credits, etc. It also provides guidance as to where each member should report each item on his own tax return (Form 1040). K-1s includes the member's "capital account," which is a concept in partnership tax law similar, but not identical, to one's basis in an asset.

Although LLCs have fewer "formalities" than corporations (i.e., LLCs do not have to hold annual meetings to elect a board of directors and officers, or file an annual report setting forth those directors and officers with the SCC), it is important to observe at least a few formalities in order to preserve the distinction between the LLC and its owners. That distinction is the basis for separating the LLC's liability to creditors and claimants from the members' personal assets. For example, the LLC's business records, finances and assets should not be co-mingled with the members' records, finances and assets. Thus, the LLC should have a separate bank account and checkbook. When contracts or correspondences are signed on behalf of the LLC, the signature should indicate the agency capacity of the signatory, i.e.

ACME, LLC

By: _____
John Doe, Manager

Important decisions should be memorialized in minutes, whether manager minutes, or member minutes (depending on who has authority to make the decision).

Conclusion

For maximum flexibility in structure, fewer formalities in how the entity functions, and possibly the best of the tax and limited liability worlds, the LLC is worth serious consideration as a choice of business entity in Virginia. This may explain why, of 47,970 new Virginia LLCs and corporations created in Virginia in 2010, nearly 72% (34,515) were LLCs.[2]

Corporations

Introduction

A Virginia corporation is a legal entity created under state law to have an identity that is separate from the identities of its owners. As such, it provides its owners (called stockholders or shareholders) with protection from the liability of the corporation's business and activities. While a stockholder's investment in the corporation is exposed to the risks of the corporation's business and activities, typically those risks do not reach beyond the stockholder's investment. Thus, creditors and claimants are generally limited to recovery from the corporation's assets; they typically cannot reach the stockholder's personal assets.

Upon incorporation, a corporation is a separate taxpayer and, as such, it pays corporate tax on the profits of the corporation's business. When those profits are distributed to stockholders in the form of dividends, the stockholders pays income tax on those dividends. To avoid this "double tax," many small business corporations elect to be taxed under Subchapter S of the Internal Revenue Code, thus becoming an "S corporation." In the absence of the S election, the corporation remains a "C corporation" and, as such, a taxpayer.

An S corporation is a "pass-through" entity for tax purposes, which means the S corporation is not taxed on its profits; rather, the stockholders are taxed. An S corporation is subject to the following restrictions, among others:

- the S corporation may have no more than 100 stockholders;
- the stockholders of an S corporation must be "eligible" (i.e., no nonresident alien, no C corporation, no partnership) – generally, this means only a natural person[3] who is a US citizen or a resident aliens;[4]
- the S corporation may have no more than one class of stock (i.e., no preferred stock); and
- the S corporation must be calendar-year taxpayer.

[2] Based on information provided to the author by the SCC Division of Information Resources.
[3] A natural person is an individual rather than a legal entity such as a corporation or partnership.
[4] A resident alien is a person who legally resides in the US, but is not a citizen.

How Organized?

A corporation is formed when Articles of Incorporation are filed with the SCC and the SCC issues a Certificate of Incorporation – essentially, the corporation's birth certificate. Articles of Incorporation may be completed and filed by anyone by accessing that form, and following the filing instructions, available on the SCC's website. The initial filing fee for a corporation is $75.[5] The SCC charges an annual fee of $100 for the privilege of remaining a Virginia corporation year to year. If the fee is not paid, the corporation will be automatically terminated and cease to exist.

Following incorporation, the corporation must act to elect its board of directors (if not named in the Articles of Incorporation), elect its officers, and issue stock to its stockholders. Typically this is done concurrently with the adoption of corporate bylaws which describe certain of the corporation's governance rules (i.e., how large the board will be, what officers are required and a description of their roles, when the annual stockholders' meeting will be held). Before the corporation commences business, it should file a Form SS-4 to obtain a separate employer identification number (EIN) for the corporation. This is a simple on-line filing. See http://www.irs.gov/businesses/small/article/0,,id=102767,00.html or Google "Apply for EIN online" and choose the IRS search result. The EIN is assigned within minutes of the online application. An EIN is required in order to open a bank account for the corporation.

If the corporation wants to elect Subchapter S status effective upon commencement of the corporation's business, the election (filed on Form 2553) must be filed within two and one-half months from the beginning of the corporation's first tax year. Thus, if the corporation begins its first tax year on November 8, the S election must be filed during the period beginning on November 8 and ending January 22 (two and one-half months) in order for the S election to apply to the corporation's short tax year (November 8 – December 31).[6] The S election must be signed by every stockholder of the corporation in order to be effective.

How Operated?

The day-to-day management of a corporation is carried out by its officers (President, Vice Presidents, etc.). Officers are elected by the board of directors and are accountable to the board. board action is required for decisions that have not been delegated to officers and for certain material decisions which are assigned to the board by statute. Unless otherwise provided by the corporation's Articles of Incorporation, bylaws or stockholders agreement, stockholders have a limited number of decisions on which their vote is required (i.e., to merge or dissolve the corporation). Their most effective power is in their ability to elect, and remove, directors. Stockholders vote according to the number of shares they have; thus, a stockholder who owns 51% of the stock, absent a special provision in the corporation's Articles of Incorporation, bylaws or stockholders agreement, controls who the directors are (and, by virtue of board

[5] These fees assume that the corporation's articles of incorporation provide for no more than 5,000 authorized shares; that is, the total number of shares the corporation can issue. 5,000 authorized shares are sufficient for most small businesses.

[6] See Example 3 of IRS General Instructions for completion of IRS Form 2553 at http://www.irs.gov/instructions/i2553/ch01.html#d0e124.

control, effectively controls who the officers are). Other major stockholder decisions, such as whether to merge or dissolve the corporation, require the vote of more than two-thirds of the voting stock of the corporation. Directors, by contrast, vote on a "one man; one vote" basis – not according to stock ownership – so absent a special provision in the corporation's Articles of Incorporation, bylaws or stockholders agreement, a majority vote of the directors controls. Corporate officers and directors owe a "fiduciary duty" to the corporation and can be exposed to liability for breaching that duty. Virginia law permits this exposure to be limited through special provisions in the corporation's Articles of Incorporation or bylaws.

Agricultural Cooperatives

Introduction

A Virginia agricultural cooperative association[7] is a corporation that conducts its business on a cooperative basis. As a corporation, a cooperative provides its owners with protection from the liability associated with the cooperative's business and activities. While an owner's investment in the cooperative, including the owner's right to patronage, is exposed to the risks of the cooperative's business and activities, typically those risks do not reach beyond the owner's investment. Thus, creditors and claimants are generally limited to recovery from the cooperative assets; they typically cannot reach the owners' personal assets.

A cooperative can be organized as either a nonstock or stock corporation, though most choose to be stock corporations. This guide focuses on cooperatives organized as stock corporations, but the concepts are similar for both types of cooperatives. For a cooperatives organized as a stock corporation, only a limited portion of a cooperative's net earnings is returned to the stockholders (referred to as "members" in this guide) based on the number of shares they own; historically and by law in many states, no more than 8% of net earnings per year. Most of a cooperative's net earnings are returned to the cooperative's members – as cash and/or equity allocations – *on the basis of how much business the member did with the cooperative during the year.* This method of allocating earnings is generally known as a "patronage refund system," and the returns themselves are commonly called "patronage refunds." Sharing profits on a patronage basis is the hallmark of a cooperative.

Cooperatives also have unique control characteristics. Whereas corporations are controlled by stockholders according to the number of shares they own, members in a cooperative are entitled to only one vote, regardless of the number of any shares they own. Preferred stockholders of a cooperative, if any, are not permitted to vote at all except in limited circumstances. Otherwise, only members may vote. Because only bona fide producers of agriculture may be admitted as a member of a cooperative, producers have voting control of a cooperative, and this control is strictly democratic ("one man, one vote").

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[7] There are two kinds of Virginia cooperatives: an agricultural cooperative, as this article describes, and a cooperative that does not meet the qualifications for an agricultural cooperative but may nonetheless form a cooperative to conduct business on a cooperative basis. Typically, these types of cooperatives are consumer or marketing cooperatives.

How Organized?

A cooperative is formed when Articles of Incorporation are filed with the SCC and the SCC issues a Certificate of Incorporation – essentially, the cooperative's birth certificate. Articles of Incorporation for cooperatives have special requirements, both in content and filing requirements, so those wishing to form a Virginia cooperative are advised to seek the assistance of an experienced cooperative attorney.

Following incorporation, the cooperative's board of directors must act to elect the cooperative's officers, issue stock to its members, and, typically, enter into producer contracts with its members. Typically this is done concurrently with the adoption of cooperative bylaws which describe certain of the cooperative's governance rules as well as the patronage refund system. Before the cooperative commences business, it should file a Form SS-4 (checking the "farmers cooperative" box if it will be an exempt farmers' cooperative as described below) to obtain a separate employer identification number for the corporation. This is a simple on-line filing. See http://www.irs.gov/businesses/small/article/0,,id=102767,00.html or Google "Apply for EIN online" and choose the IRS search result. The EIN is assigned within minutes of the online application. An EIN is required in order to open a bank account for the cooperative.

How Operated?

A Virginia cooperative must have at least five directors, at least one of whom must be appointed by the Director of the State Agricultural Extension Service (such director being known as the "public director"). The board is responsible for oversight of cooperative's business and affairs. Board action is required for all decisions that have not been delegated to officers and for certain material decisions which are assigned to the board by statute.

The day-to-day management of a cooperative is carried out by its officers (President, Vice Presidents, etc.). Officers are elected by the board of directors and are accountable to the board. Corporate officers and directors owe a "fiduciary duty" to the cooperative and can be exposed to liability for breaching that duty. Virginia law permits this exposure to be limited through special provisions in the cooperative's Articles of Incorporation or bylaws.

Unless otherwise provided by the cooperative's Articles of Incorporation or bylaws, members have a limited number of decisions on which their vote is required (i.e., to merge or dissolve the cooperative). Their most effective power is in their ability to elect, and remove, directors. Unlike other corporations, cooperative members vote on a "one man, one vote" basis.

As stated above, most of a cooperative's net earnings (or "margins") are refunded to its members annually based on their level of patronage of the cooperative's business. Annual patronage refunds are typically distributed partly in cash and partly in the form of a written notice of allocation of patronage equity, which represents margins retained in the cooperative as a capital investment by patrons to help finance the cooperative's operating needs. The retained portion of a patronage refund is allocated to each member's patronage equity account and paid out to the member at a later date. A cooperative's debts are entitled to priority over all patronage equity allocations.

Patronage refunds can be "qualified" or "nonqualified." Qualified patronage refunds are taxed to the member in the year they are allocated, and at least 20% of a qualified patronage refund must be paid in cash. Members must consent to this tax treatment for a given year at the dollar amount stated in a written notice of allocation of a qualified patronage refund or a per-unit retain certificate received from the cooperative. Cooperatives generally use a bylaw provision to satisfy the consent requirement for member patrons. Nonqualified patronage refunds are taxed to the cooperative in the year of their allocation and taxed to the member in the year the nonqualified patronage equity allocation is paid out in cash, or redeemed. Patronage refunds are paid no later than 8-1/2 months after the close of each fiscal year. Although patronage refunds may also be made to non-member patrons and the tax treatment is the same, agricultural cooperatives typically limit their business with non-member patrons to preserve tax-favored, exempt status.

Another way cooperatives can raise capital is through "per-unit retains." A per-unit retain is a deduction by the cooperative from sale proceeds based on the value or quantity of products marketed for a member. Similar to patronage equity allocations, per-unit retains are reported to patrons on written certificates and can be "qualified" or "nonqualified" in their tax treatment. The key difference between patronage refunds and per-unit retains is that patronage refunds are based on the cooperative's margins while per-unit retains are based on the amount of business conducted without regard to margins.

A cooperative is a type "pass-through" entity for tax purposes, meaning that earnings derived from members' activities can avoid taxation at the corporate level. Instead, earnings are taxed only once, to the members. All cooperatives are entitled to this basic type of preferred tax treatment. Certain cooperatives are entitled to even better tax benefits: pass-through treatment even on income derived from sources other than patrons' activities, as well as on stock dividends. These cooperatives are referred to as "Section 521 cooperatives," or, most typically, as "exempt farmers' cooperatives." Among other requirements, exempt farmers' cooperative must either market agricultural products or purchase supplies or equipment for those engaged in producing agricultural products. They must apply with the Internal Revenue Service for recognition of their exempt status by filing a Form 1028 application. As noted in this guide under the section entitled "*A Word About Securities Laws*," a cooperative's tax-exempt status can be a significant advantage in raising private capital.

All cooperatives (whether or not they are exempt as described above) must file an annual income tax return on Form 1120-C showing the cooperative's income, deductions and other required information. Cooperatives need not be a calendar-year taxpayer. Regardless of the cooperative's tax year, however, it must furnish a Form 1099-PATR by January 31 of each year to each person to whom the cooperative has paid at least $10 in patronage refunds during the prior calendar year. Form 1099-PATR reports a member's patronage refunds, per-unit retain allocations, and patronage or retain redemptions for the year. The member, in turn, reports these amounts on his own tax return – Form 1040 for members who are individuals. If the cooperative pays any dividends to its members, it reports them to its members on Form 1099-DIV, the same as a non-cooperative stock corporation.

As a corporation, cooperatives require more formalities than other forms of entity such as limited liability companies. Cooperatives must hold annual meetings to elect a board of directors and officers; they must file an annual report with the SCC setting forth those directors and officers; minutes are required to evidence proper decision making; stock is typically certificated and thus stock books need to be maintained accurately; etc. Beyond this, and as with other forms of entities, the cooperative's business records, finances and assets should not be commingled with the members' records, finances and assets. Thus, the cooperative should have a separate bank account and checkbook. When contracts or correspondences are signed on behalf of the cooperative, the signature should indicate the agency capacity of the signatory, i.e.,

ACME Cooperative, Inc.

By: _____
John Doe, President

Where too many of these formalities are ignored, the "separateness" of the cooperative versus its members is eroded, increasing the risk that creditors and claimants will be able to ignore the distinction between the cooperative and its members and reach the members' assets. This is referred to as "piercing the corporate veil," and, while these cases are uncommon, they do exist and occur.

Conclusion

Cooperatives are well-suited for agricultural business where earnings are going to be shared on the basis of how much business the owners have conducted with the cooperative. As cooperatives require specialized recordkeeping and tax reporting because of the patronage refund system, they should not be undertaken without the assistance of an accountant and/or attorney knowledgeable in cooperative accounting and tax.

A Word About Securities Laws

Whenever a business needs to raise capital through the contribution of funds by investors, the business must consider how to raise capital in compliance with applicable state and federal securities laws. Securities laws require that the offer or sale of a security (which includes partnership interests, LLC membership interests, and stock in a corporation or cooperative) be registered with the applicable state securities division(s) and the U.S. Securities and Exchange Commission unless the offer or security is exempt from registration. As registration is cost-prohibitive for small businesses, finding that exemption is key to lawful securities offering.

Possible federal exemptions from registration include:

- A transaction not involving a public offering, or, a so-called "private placement." While "private placement" is not defined by statute, a number of "safe harbors" have been articulated such that, if the securities offering is made in compliance with one or more safe harbors, it will be deemed to be a private placement and thus exempt from registration. These safer harbors are articulated under "Regulation D" of the Securities

Act of 1933. A description of Regulation D is beyond the scope of this guide, but one key understanding of the Regulation is that only one of the safe harbors – referred to as "Rule 506" – effectively preempts the registration requirements of state securities laws. Thus, if an offering is compliant with Rule 506, corresponding state law registration exemptions need not be found.

- Offerings made exclusively to residents of a single state by a company both resident and doing business in that state, or, the so-called "intrastate exemption." This is a fragile exemption that is easily lost if an offer is directed, or a sale is made, to an out-of-state resident, however, if an offering is truly local in nature and a compatible state law registration exemption can be found, it may be an appropriate exemption on which to rely.

- Securities issued by a tax-exempt farmers' cooperative. Tax-exempt farmers' cooperatives may sell their stock without registering them at the federal level. States typically, and Virginia specifically, exempts cooperatives incorporated in their state from securities registration. Thus, a Virginia-incorporated cooperative that has also received tax-exempt (Section 521) status may issue securities without registering those securities at the federal or state level. However, if the offering goes outside the state of incorporation of the cooperative, an exemption in those outside states must be found.

Regardless of whether the offering is exempt from registration, whenever a business raises money by issuing securities, it must be mindful of federal and state anti-fraud rules. These rules make it unlawful to make untrue statements of material fact, or to omit to state material facts which are needed to make an informed investment decision. The way to mitigate the material risks associated with violating these rules is by providing adequate disclosure. Typically this disclosure takes the form of a private placement memorandum which "tells the story" of the business, the security being offered, the capital needs and uses associated with the offering, and the business' management, as well as providing financial information and risk factors associated with the offering.

Securities laws compliance is sometimes overlooked by those starting a business, but the risks of noncompliance include civil and criminal sanctions for the organizers and thus should not be overlooked or minimized.

Organizational Steps

As the working group for a new venture gets started, the following steps are recommended:

1. **Describe the potential business in writing.** As a first step, the group should agree on the market problem or need, the proposed business solution, and the basic components of that business solution. A very good strategy in problem definition is to describe what the group would like to have happen as a result of solving the problem. This written document does not need to be lengthy but needs to include several key bits of information about the potential business such as:

- What are the financial resources and how will the needed business capital be raised?
- What products and services will the business provide/sell?
- How will the business market its products and services?
- How will the business operate on a day-to-day basis?

Often a group will elaborate on this initial document to construct a business plan. The business plan is the design for project implementation and will serve as a blueprint for the group's responses during project operations.

2. **Collect Funds for Start-up Expenses.** Whether through loans or donations or both, the founding group should contribute the money needed to hire the professional advisors needed to launch the project. This should not be, or be described as, equity in the new venture unless steps are taken to comply with applicable securities laws.

3. **Select Legal Counsel:** After reviewing the information in this guide and completing the above steps, the group may be ready to select their legal advisor.

   a. **Build a "short list."** Create a list of potential attorneys to work with on the formation. From this list select a couple of attorneys to interview. Have the same key group members at these interviews. At the interview, ask the attorney to outline the steps for accomplishing the preliminary business plan. Following the interview, if the attorney is still a potential candidate, ask the attorney to propose an engagement letter outlining the scope of services, timeframe for accomplishing the work, and fees.

   b. **Check references.** Do not skip this step as results speak louder than words. The references received from the attorney may not identify the specifics of the problem for which the attorney was engaged, but calling these references should reveal whether the reference's matter was handled discreetly, whether their problem was solved, whether their costs were contained and whether they were pleased with the results.

   c. **Select the Attorney.** Carefully evaluate the proposed solutions and select the one that best addresses the group's needs. Sign the engagement letter with the attorney selected.

4. **Accomplishing the project.** The group's legal advisor will have the lead role; however, the following is suggested as a way of accomplishing the project as cost-effectively as possible. These tasks include:

   - Making sure that roles and lines of communication are clear
   - Designating a group member to be the primary contact for the attorney
   - Holding a kick-off meeting between the working group and the attorney
   - Preparing a project management timeline with the attorney and the group. Include milestones and systems to track and report progress. The attorney should present documents, such as bylaws and articles of incorporation, to the group at milestones, for check-in and possible re-direction.
   - Managing the cost and progress reporting process for the funds are involved.

About…

Virginia FAIRS, the Virginia Foundation for Agriculture, Innovation and Rural Sustainability, a 501 (c) (5) corporation organized in Virginia, is a Cooperative Development Center. With the assistance and cooperation from partners such as the Virginia Farm Bureau Federation (VFBF), the Virginia Department of Agriculture and Consumer Services (VDACS), the Virginia Department of Business Assistance (VDBA) and Virginia Cooperative Extension (VCE), Virginia FAIRS offers assistance to individuals, cooperatives, small businesses and other similar entities in rural areas to enable and assist cooperative and business development. Virginia FAIRS also works closely with USDA Rural Development.

The mission of Virginia Fairs is to assist rural Virginians in developing and advancing their agricultural, economic and social interests to enhance their quality of life. The main goals of the Center are to facilitate and coordinate technical and financial assistance to provide traditional and innovative solutions that will allow farmers in Virginia to:

1) explore and develop opportunities using existing production and market resources and risk management techniques;
2) transition from traditional production and marketing into more financially rewarding agricultural enterprises;
3) develop value-added and high-value agricultural product and enhanced market opportunities;
4) address challenges facing farmer's production and marketing resources;
5) address issues affecting the sustainability of rural Virginia;
6) establish a centralized resource for farmers to easily access cooperative development and value-added information; and,
7) better utilize and coordinate the wide-ranging expertise available in Virginia and as such better facilitate and enhance current and future efforts and programs in these areas.

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The attorneys at **Lenhart Obenshain** have a long tradition of representing agribusiness, their managers and owners. From the traditional farming operations in dairy, poultry, beef, orchards and crops, to integrated producers, to more recently developed agribusinesses such as organic meat, dairy and produce, greenhouse produce, nurseries, water gardens, farmers' markets, and other agribusinesses with ecotourism applications, our experience is a valuable resource in facing the unique business, real estate, and wealth management issues involved. Increasingly, these issues include the protection and stewardship of natural resources – both known resources, such as timber, wind, solar and water, and unknown resources, such as underground aquifers, minerals and natural gas yet to be discovered. Our Harrisonburg, Virginia office is situated on the eastern boarder of the Marcellus and Utica Shales, positioning the firm's attorneys to exploit years of experience in representing landowners in negotiations with gas companies. Harrisonburg is located in Rockingham County, the largest agricultural county in the Commonwealth and one of the largest in the eastern United States. The following is representative of our work:

- ***Counsel to Agribusinesses.*** Formation of poultry cooperative involving multi-million dollar private capitalization (sale of common and preferred securities), bank financing and grant funding, and business permitting, enabling 130 farm families-growers to take local control not only of their farm operations but of the poultry business for which they produce; sales of national poultry companies and apple products company; formation and capitalization of processing facility for the benefit of a five-county farming community; formation and capitalization of cooperative grocery stores; formation of organic foods company and farmers' markets. Lenhart Obenshain's tax and business experience provides a solid foundation for helping agribusiness ventures choose the right entity, whether a cooperative, limited liability company, corporation or some other form.
- ***Farm Succession Planning.*** Lenhart Obenshain's attorneys have assisted thousands of families in solving the challenging problem of how to divide a farm, a spring, a unique scenic or natural resource, a family mountain retreat, or the gas, solar or wind potential of certain real estate holdings among the next generation of owners. Our estate tax attorneys not only minimize, if not eliminate, estate and gift taxes, they are highly skilled in minimizing the family tension that goes along with developing the appropriate division plan. We also assist with preservation of farmland through conservation easements, negotiation of farm financings, and the use of available tax credits.
- ***Counsel for Owners/Developers of Natural Resources.*** Counsel since 2002 to Virginia's first wind farm; negotiation of wind farm leases, water agreements, timber contracts, and mineral and gas contracts.