SELECTING A BUSINESS STRUCTURE

An Informational Guide to Forming Businesses

By

Chris Williams
Vice-President of Operations, 21st Century Alliance, Manhattan, Kansas
Previously, Extension Assistant, Department of Agricultural Economics, Kansas State University

David Barton
Director, Arthur Capper Cooperative Center
Professor, Department of Agricultural Economics, Kansas State University

David Coltrain
Extension Assistant, Arthur Capper Cooperative Center
Department of Agricultural Economics, Kansas State University

May 2000

Arthur Capper Cooperative Center
Department of Agricultural Economics
Cooperative Extension Service
Kansas State University
# TABLE OF CONTENTS

**CHAPTER 1: INTRODUCTION TO LEGAL FORMS OF BUSINESS** ........................................... 4
  1.1 DETERMINING YOUR BUSINESS STRUCTURE ...................................................... 4
  1.2 FACTORS OF SELECTION ............................................................................... 4
    1.21 Liability ........................................................................................................ 4
    1.22 Taxation ....................................................................................................... 4
    1.23 Legal Filing Formalities ............................................................................. 5
    1.24 Financing .................................................................................................... 5
    1.25 Management .............................................................................................. 5
    1.26 Life of the Business ................................................................................. 5
  1.3 STRUCTURE OF THIS PAPER ........................................................................... 5

**CHAPTER 2: PROPRIETORSHIPS AND PARTNERSHIPS** .................................................. 5
  2.1 SOLE PROPRIETORSHIPS DEFINITION ........................................................... 5
    2.11 Liability ....................................................................................................... 5
    2.12 Taxation ..................................................................................................... 5
    2.13 Legal Filing Formalities ........................................................................... 5
    2.14 Financing ................................................................................................... 6
    2.15 Management ............................................................................................. 6
    2.16 Life of Business ....................................................................................... 5
  2.2 GENERAL PARTNERSHIPS DEFINITION ............................................................ 6
    2.21 Liability ....................................................................................................... 6
    2.22 Taxation ..................................................................................................... 6
    2.23 Legal Filing Formalities ........................................................................... 6
    2.24 Financing ................................................................................................... 6
    2.25 Management ............................................................................................. 6
    2.26 Life of Business ....................................................................................... 6
  2.3 LIMITED PARTNERSHIPS DEFINITION ............................................................... 7
    2.31 Liability ....................................................................................................... 7
    2.32 Taxation ..................................................................................................... 7
    2.33 Legal Filing Formalities ........................................................................... 7
    2.34 Financing ................................................................................................... 7
    2.35 Management ............................................................................................. 7
    2.36 Life of the Business ................................................................................. 7
  2.4 LIMITED LIABILITY PARTNERSHIPS DEFINITION ............................................. 7

**CHAPTER 3: CORPORATIONS** ....................................................................................... 7
  3.1 C CORPORATION DEFINITION ......................................................................... 7
    3.11 Liability ....................................................................................................... 8
    3.12 Taxation ..................................................................................................... 8
    3.13 Legal Filing Formalities ........................................................................... 8
      *Articles of Incorporation* .............................................................................. 8
      *Corporate Bylaws* ....................................................................................... 9
    3.14 Financing ................................................................................................... 10
    3.15 Management ............................................................................................. 11
    3.16 Life of the Business ................................................................................. 11
TABLE OF CONTENTS, CONTINUED

3.2  S CORPORATION DEFINITION ................................................................. 11
  3.21 Liability ......................................................................................... 11
  3.22 Taxation ....................................................................................... 11
  3.23 Legal Filing Formalities ................................................................. 12
    SC Eligibility Requirements ............................................................... 12
    Making an SC Election ..................................................................... 14
    Termination of an S Election ............................................................ 14
    New Election After Termination ....................................................... 14
  3.24 Financing ..................................................................................... 14
  3.25 Management ............................................................................... 14
  3.26 Life of the Business .................................................................... 14

CHAPTER 4: LIMITED LIABILITY COMPANIES ................................................. 15
  4.1 LIMITED LIABILITY COMPANY DEFINITION ..................................... 15
  4.2 FACTORS OF SELECTION ................................................................. 15
    4.21 Liability ..................................................................................... 15
    4.22 Taxation .................................................................................... 15
    4.23 Legal Filing Formalities .............................................................. 17
      Articles of Organization ................................................................. 17
      Operating Agreement ................................................................... 17
      Annual Report .............................................................................. 17
    4.24 Financing .................................................................................. 18
    4.25 Management ............................................................................ 18
    4.26 Life of the Business .................................................................. 18

CHAPTER 5: COOPERATIVES ............................................................................ 19
  5.1  COOPERATIVE DEFINITION ............................................................ 19
  5.2  FACTORS OF SELECTION ................................................................. 19
    5.21 Liability ..................................................................................... 19
    5.22 Taxation .................................................................................... 19
    5.23 Legal Filing Formalities .............................................................. 20
      Articles of Incorporation ............................................................... 20
      Cooperative Bylaws ................................................................. 21
      Annual Report .............................................................................. 21
    5.24 Financing .................................................................................. 22
    5.25 Management ............................................................................ 22
    5.26 Life of the Business .................................................................. 22

REFERENCES .............................................................................................. 22

ACKNOWLEDGEMENT
The authors appreciate the review and advice given by Roger McEowen, Associate Professor of Agricultural Law, Kansas State University and Terry Bertholf, General Counsel, Kansas Farmers Service Association.
CHAPTER 1: INTRODUCTION TO LEGAL FORMS OF BUSINESS

1.1 DETERMINING YOUR BUSINESS STRUCTURE

Organizers of new businesses need to structure their businesses in a way that best meets their individual and collective needs. Structure has many facets including organizational, operational, marketing, financial and legal. The focus here is on legal business structure. However, this decision depends heavily on the choice of organizational, operational, marketing, and financial strategy and structure.

The principal forms of business organization discussed here are as follows: (1) sole proprietorship (SP), (2) general partnership (GP), (3) limited partnership (LP), (4) limited liability partnership (LLP), (5) C corporation (CC), (6) S corporation (SC), (7) limited liability company (LLC) and (8) cooperative corporations (co-op).

Simply defined, a SP is a business owned and controlled by a single person. A GP is an association of two or more people to carry on a business for profit. A LP is an association of two or more people with at least one general partner and at least one limited partner conducting business for the mutual benefit of the owners. LLPs are modifications of existing partnership laws that limit personal exposure of some partners in a firm. A CC is a legally formed business authorized to act with the rights and liabilities of a person independent of the shareholders. A LC is a special type of corporation, similar to a CC that has met certain requirements set by the Internal Revenue Service (IRS) and has made an election allowing the corporation to be taxed as a partnership. A LLC, a relatively new business form, has the pass-through tax advantages of a partnership and the limited liability of a corporation. A co-op is similar to a CC, except it is user-owned, user-controlled, and user-financed and has the pass through tax advantages of a partnership.

No one form of business organization is suited for all different business situations. Your goal should be to select the legal form that best meets the needs of the business and its owners. We suggest that legal counsel and advice from other business professionals be sought early in the decision-making process when you start, restructure or add to a business.

Choosing a business form is one of the most important decisions a business makes. A business should evaluate the options available and choose the form that best meets its needs. Although this process may be time consuming and have associated costs, it is one of the best investments a business can make.

Keep in mind that the business form selected is not cast in stone. Changes may occur that make it appropriate to change the way your business is structured. Internal changes, such as a joint venture or acquiring another company, may provide a reason to change your business structure. External changes, such as legal or tax developments, may also influence your business structure.

However, it can be very costly to change your business form, primarily because of tax consequences. This possibility needs to be considered when you organize a new business.

The goal of this paper is to acquaint owners, managers, partners, patrons, customers and boards of directors with comparative advantages and disadvantages of these business structures. This information will help guide you in selecting a business form for a new business or changing the form of an existing business.

1.2 FACTORS OF SELECTION

There are six key factors organizers of a new business should consider when selecting a legal business structure. They are the (1) liability obligation of the individual owners, (2) income tax obligation of the business and its individual owners, (3) legal filing formalities, (4) financing and liquidity of equity investments, (5) management flexibility and (6) life of the business. It is important to evaluate these factors to determine which structure is best for a business.

These six factors of selection will be evaluated for the eight alternative business forms discussed in this report. Each factor will be examined from the viewpoint of the owner, and some advantages or disadvantages will be discussed.

1.21 Liability

A major objective of most equity investors is to limit their personal liability in a business venture. This is especially true for investors who do not wish to participate in the management of the business. Corporations are viewed as more stable to investors, and liability is usually not an issue. However, the introduction of LLCs and LLPs has given liability protection to investors while avoiding the disadvantages of the corporate structure, such as double taxation. This report will examine the liability limitations placed on owners by each business form discussed.

1.22 Taxation

The reason most people invest in a business is to meet their needs. One primary goal is to make a profit. The goal is to put the majority of business income into the pockets of the owners. Income tax laws greatly affect tax liabilities that investors and businesses must pay. Income taxes may be payable at the federal, state and local levels. Of major concern is whether income is subject to single taxation, as is true for proprietorships and partnerships, or double taxation, as is the case for C corporations. Double taxation occurs when income is taxed at both the business or corporate level and at the owner or individual level. For example, net income of a CC is normally taxable at the corporate level. The portion of the after tax income distributed as dividends is also taxed at the owner level. Although tax laws may change, the basic concepts stay the same. Tax rate changes may shift the relative advantages of each business form, but
they should not be the sole criteria for choosing a business form.

1.23 Legal Filing Formalities
Some business forms require that legal papers be filed with state agencies in order to legally conduct business in the state. Filing formalities for each business form will be discussed.

1.24 Financing
Financing is an issue for almost every business. For large businesses with a corporate structure, financing is usually easier. The main types of financing are debt and equity.

1.25 Management
Management flexibility is an important factor in choosing a business form. Corporations have the most flexibility in management arrangements. Management can be established in any way deemed appropriate by the board of directors. In contrast, limited partners in a LP cannot participate in management without losing their liability limitations. Choosing the business form that allows for a management structure best suited for your business should be an important consideration in forming a new business or changing an existing one.

1.26 Life of the Business
The life of a business should be considered when choosing a business form. The life of some businesses legally ends when one of the principals dies or withdraws. Other businesses can live almost indefinitely even though the principals completely change, even in a short period of time. This is a major disadvantage to SPs and partnerships. The death, insolvency or decision to no longer conduct business by a partner or sole proprietor could cause the technical dissolution of the business.

1.3 STRUCTURE OF THIS PAPER
The remainder of this paper is organized as follows. Chapter 2 gives a quick overview of business organizations with a relatively small number of owners and evaluates the six factors of business selection. Chapter 3 examines more closely the advantages and disadvantages of corporations in the factors of business selection. Limited liability companies are similarly analyzed in Chapter 4. Chapter 5 explains the factors of business selection related to cooperatives.

A word of caution. This brief overview is not intended to be an all encompassing guide to the formation and operation of any business form but a general guide to the most popular forms of business. Before forming a new business or changing your current business always consult with business professionals who are competent in legal, tax, accounting, marketing, finance, operations and general organizational management.

CHAPTER 2: PROPRIETORSHIPS AND PARTNERSHIPS
Proprietorships and general partnerships are very similar with respect to the two selection criteria of most interest, taxation and liability. However, two variations of partnerships, limited partnerships and limited liability partnerships, offer additional limited liability advantages. In this chapter, we describe and compare sole proprietorships, general partnerships, limited partnerships and limited liability partnerships.

2.1 SOLE PROPRIETORSHIPS (SP)
DEFINITION
A SP is a business owned and controlled by a single person. Although SPs may have employees, the business is viewed legally as an extension of the owner. All responsibilities, profits and losses are the owner’s.

2.11 Liability
Unlimited liability is probably the biggest disadvantage of a SP. Since the business is viewed as an extension of the person, the owner is personally responsible for any business loss or liability. This is a major consideration, especially for individuals who wish to protect personal assets from losses. A sole proprietor has unlimited liability for doing business.

2.12 Taxation
Single income taxation is probably the biggest advantage of a SP. The simplicity of single profit distribution and taxation help make SPs a popular business form, especially for small businesses. SPs pay no income taxes at the business level. Income is taxed through the owner’s individual income tax return at the individual tax rate. This might be lower than the corporate rate, depending on the level of profits and the tax rates in effect. Sole proprietors also must pay self-employment tax on income. Losses from start-up businesses can be used by SPs to offset profits from other business ventures.

Prior to 1989, the burden of self-employment tax was a disadvantage to SPs, but since then there has been more parity in the treatment of self-employed people and their employees by allowing the deduction of one-half of the self-employment tax from their taxable income.

2.13 Legal Filing Formalities
A SP is the simplest and least expensive way to form a business, making it the most popular business form for small businesses. It requires the least sophisticated organizational structure and financial accounting system. No formal requirements are needed to form a proprietorship, unless a special license is required or unless the business has registered a business name other than the proprietor’s name.
2.14 Financing
Financing, or capitalization, is often difficult for sole proprietors. Capitalization is limited to the personal funds of the proprietor and the amount that can be borrowed. Financing is one reason large business ventures are not created by a sole proprietor.

2.15 Management
Management flexibility is an advantage for sole proprietors, if the owner has the abilities to manage the business effectively. Owners are free to make management decisions without consulting partners or board members. Owners simply make decisions and implement them. This is not to say that sole proprietors do not hire management. Outside managers may be hired to operate the business, but ultimately responsibilities fall on the owner.

2.16 Life of the Business
A SP is terminated when the owner dies or decides to terminate the business. A proprietorship usually can be changed into a partnership, a LP or a corporation without incurring tax obligations. However, there may be some tax obligations. Professional advice should be sought.

2.2 GENERAL PARTNERSHIPS (GP) DEFINITION
A partnership is an association of two or more people to carry on, as co-owners, a business for profit. Owners contribute property, money or services to the business for their common benefit. Partners share profits from the business in prearranged proportions. GPs allow all partners to participate in management but give no liability protection to any partner. This differs from limited partnerships, discussed later.

A partnership is the simplest way for two or more entities, such as individuals, trusts, partnerships, limited liability companies, corporations, or any combination thereof, to conduct business together. A partnership is able to conduct any legal business activity.

2.21 Liability
The biggest disadvantage of a partnership is that full liability for any partner’s actions falls totally on all partners. Indeed, every partner is an agent of every other partner. No protection from liability is granted any partner. This means that all partners will be held accountable for any debt incurred, any contract entered into, or any other obligation that any partner enters into on behalf of the partnership. This can cause serious problems, especially in situations where partners with poor management capabilities are making management decisions. This is one reason partnerships are seldom used for large businesses.

2.22 Taxation
Taxation and the costs associated with accounting are usually advantages of a partnership. Profits and losses are reported on the owners’ personal income tax returns for each partner’s pro rata share. Profits are taxed at the individual income tax rate. There is no double taxation, since the partnership does not file an income tax return. It only files a 1065 informational form. Partners also must pay self-employment tax on income earned through the partnership.

A possible disadvantage is that profits from business operations have to be reported on the owners’ income tax return even if they were not distributed. This could cause negative cash flows to partners if the tax liability is larger than the profits distributed.

Another disadvantage is the inability to provide fringe benefits at a reduced tax cost in GPs. Unlike corporations, fringe benefits, such as medical insurance or medical reimbursement plans, are not deductible business expenses for partnerships.

Generally, a partnership can be converted to a corporation tax free. It is important to consider tax obligations when reorganizing a business structure. Be cautious. Determine if any tax burdens of a restructuring and the costs associated with forming a corporation outweigh the benefits of doing so.

2.23 Legal Filing Formalities
A partnership requires no formal documentation be filed with a state agency and no formal written agreement between partners. Although not required, it is highly recommended that a partnership agreement be drafted by an attorney and signed by all partners. This serves as a regulatory device for any disputes that may arise.

A partnership agreement should discuss several details: (1) its purpose, (2) its duration, (3) how termination will be handled, (4) how management decisions will be addressed, (5) how capital will be acquired, and (6) how profits and losses will be distributed. A good rule of thumb is this: If you think there could be a dispute over it, settle it in a partnership agreement before you start your new venture.

If all questions are addressed in the partnership agreement, the document could be quite lengthy. For this reason, a partnership is sometimes considered one of the most difficult business structures to form.

2.24 Financing
Financing for a partnership is usually easier than for a SP. Partnerships can add partners to acquire capital. However, managerial control is usually lost as more partners are added to a GP. People who invest in a GP usually want some say in how the business is managed.

2.25 Management
Management is a consideration in any business. When many partners operate a business, management has the potential to become a problem. Conflicts could arise on how the business should operate because there are no formal agreements as to an assigned management hierarchy.

2.26 Life of the Business
Any changes in a partnership group cause a technical dissolution, but not necessarily a liquidation of the partnership business. If a dispute cannot be settled, the partnership could be terminated and cease to exist. This instability is a drawback of the partnership form.

Lack of business continuity also can be a disadvantage, since the business could be terminated with the death of a partner or if a partner should decide to leave the partnership.
A form of doing business similar to a partnership is a joint venture. The primary difference is that a joint venture is less general. Although joint ventures and partnerships are two different business forms, joint ventures are generally governed in accordance with the laws of a partnership.

### 2.3 LIMITED PARTNERSHIPS (LP)

#### DEFINITION

A LP is an association of two or more owners with at least one general partner and at least one limited partner. Owners contribute property, money or services to carry on the business for their common benefit. The partners share the profits from the business in proportion to their ownership share.

#### 2.31 Liability

One of the major differences between GPs and LPs is the relationship of liability among general and limited partners. Personal liability from business activities for general partners is unlimited. However, limited partners receive personal liability protection from business activities. Limited partners risk only the amount they invest.

#### 2.32 Taxation

Taxation of a LP is the same as for a GP. No income is reported at the partnership level. All profits and losses are reported through the owners’ individual income tax returns. Although the business does not file an income tax return, it must file an informational form that reports how business profits and losses will be divided among owners.

#### 2.33 Legal Filing Formalities

The formation of a LP is more formal than for a GP. A LP Certificate must be filed with the Secretary of State to form a LP.

#### 2.34 Financing

Financing for a LP is usually easier than for a SP or GP. If investors can be found who will invest without desiring participation in management, a LP can be financed more easily than a GP.

#### 2.35 Management

Management is another major difference between LPs and GPs. Only general partners are allowed to participate in the management of the business. They receive full liability for all business debts or obligations. Limited partners receive liability protection from business operations and risk only their investment. Limited partners are not allowed to actively participate in management of the business. If limited partners are found to be actively participating in management, limited liability is lost, and they are considered active general partners.

#### 2.36 Life of the Business

The life of a LP is much the same as a GP. The death or dissolution of a partner, general or limited, could cause the technical dissolution of the partnership. LPs are also easily converted to other tax free business entities.

### 2.4 LIMITED LIABILITY PARTNERSHIPS (LLP) DEFINITION

The Limited Liability Act is a modification of existing partnership laws and provides more limits to personal exposure of partners in regards to obligations of other partners in the firm. LLPs are used primarily by business associations of professionals.

LLPs are similar to LPs with respect to factors of business selection, except there are no restrictions on active participation in management by limited liability partners. LLPs give no protection from the partners’ own acts and omissions or against other partnership obligations such as leases, loans or trade accounts payable.

### CHAPTER 3: CORPORATIONS

By law, a corporation is a legal entity or “person” in itself. Corporations are formed by following a formal process of incorporation set forth by state statutes. A corporation can be viewed as an artificial individual created to conduct business by acquiring assets, hiring employees, paying taxes and facing pertinent legal issues including litigation. A corporation may also own property, enter into contracts and borrow money.

There are many types of corporations. The two most common types are described in this chapter, C corporation and S corporation. A third type, cooperative corporation, is described in Chapter 5.

#### 3.1 C CORPORATION (CC) DEFINITION

A CC may be either publicly held or closely held. Publicly held corporations are owned by many people and have stocks that are traded on securities exchanges or have some form of public exchange process and price disclosure. The exchange of stocks of publicly held corporations is generally unrestricted. Closely held corporations, as the name suggests, are corporations that are closely held by a few shareholders. Many times shareholders of a closely held corporation take active management roles. The stock of a closely held corporation is not traded publicly, and its transferability is often restricted. This type of corporation is common to farming corporations and small businesses that wish to keep ownership and control confined to a select group of people. Some specific types of closely held corporations include personal holding companies and personal service corporations. These types of corporations are subject to specific tax regulations.
3.11 Liability

One of the biggest advantages of a CC is limited shareholder personal liability from business activities. Shareholders are not personally liable for debts or obligations incurred by the corporation. Shareholders generally can lose only the amount they have invested in the corporation.

3.12 Taxation

CCs pay income taxes on taxable income at the corporate level. Income distributed to owners as retained earnings is only taxed once at the corporate level. Income distributed to owners as dividends is taxed at the corporate level and the dividends are also taxable income for the owners.

Corporate tax rates are different than individual tax rates. Tax advantages or disadvantages of a corporation for each individual owner depend on the individual’s income level as well as the deductibility of fringe benefits owners receive from the corporation.

Double taxation on dividends is one of the biggest disadvantages of a CC since CCs pay corporate tax at the business level, and shareholders pay income tax on dividends at their individual income tax rate.

Corporations, like individuals, usually pay state income tax as well as federal income tax. As an example, corporations doing business in Kansas or deriving income from Kansas sources are subject to a tax of 4 percent of taxable income plus a surtax of 3.35 percent of Kansas taxable income in excess of $50,000.

Organizations that are exempt from Kansas corporate income tax include the following:
1. Organizations exempt from federal income taxes under Internal Revenue Code provisions.
2. Insurance companies.
3. Banks, trust companies, savings and loan associations, credit unions and other organizations specifically exempt under Kansas law.

CCs have the most flexibility in choosing a taxable year. This can be especially beneficial to businesses that have a “busy season.” It can be helpful to have the taxable year begin just before the busiest part of the year. In doing so, a business will have more time to make adjustments to eliminate paying more income tax than is necessary.

A corporation must use the accrual method of accounting, but there are exceptions to this rule. A few types of CCs are exempt from this rule. They include the following: (1) corporations engaged in farming, (2) qualified personal service corporations and (3) corporations whose average annual gross receipts for the three-year period preceding the taxable year do not exceed $5 million. Qualified personal service corporations are ones whose activities involve the performance of services in health, law, engineering, accounting, architecture, actuarial science, performing arts or consulting, and substantially all of whose stock is held by its employees, their estates or their heirs (but only for the two-year period after death).

It is difficult to avoid double taxation on some corporate income. Corporations are taxed at the entity level, and shareholders pay income tax on dividends paid to them. Those dividends are not deductible to the corporation.

Corporations are subject to an alternative minimum tax of 20 percent of the corporation’s alternative minimum taxable income to the extent that the alternative minimum taxable income exceeds an exemption of $40,000. This $40,000 exemption phases out at $310,000 of alternative minimum taxable income. This is an advantage for corporations compared to other business, which pay alternative minimum tax at the higher individual rate of 24 percent.

CCs are subject to an accumulated earnings tax under Section 531. This tax is imposed on corporations that attempt to avoid shareholder taxes on dividends by retaining earnings. Most corporations can accumulate retained earnings of $250,000 without paying taxes. Accumulations above $250,000 are subject to “reasonable business needs” tests. Corporations that are ruled as having holdings in excess of reasonable business needs are subject to this tax. The reasonable needs test is a subjective test, but the IRS has established guidelines for evaluating the reasonableness of holdings. Reasonable needs for accumulated retained earnings include the following:
1. Bona fide expansion or replacement of plant and equipment.
2. Acquisition of a business enterprise.
3. Retirement of business debt.
5. Investments in, and loans to, suppliers or customers.
6. Miscellaneous needs, including reserves for contingencies.

If a corporation is found to have accumulated earnings beyond what is considered reasonable, a 39.6 percent tax is imposed. This tax is designed to force corporations to pay dividends in cases where there is no reasonable need to accumulate excess capital.

Specific tax regulations are imposed on certain types of CCs including personal holding companies (PHC) and personal service corporations (PSC). Professional tax consultants can provide specific information about tax regulations for these types of CCs.

3.13 Legal Filing Formalities

Of all business structure alternatives, corporations have the most legal formalities involved in the formation process. Use this publication only as a general guide, and confer with an attorney when you formally organize your new business.

---

1 A PHC is any corporation, unless specifically exempted, that: (1) has at any time during the last half of the year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals [known as the “stock ownership test”] and (2) at least 60 percent of its adjusted ordinary gross income is PHC income [known as the “adjusted gross income test”].

2 A PSC is any corporation whose principal activity is the performance of personal services that are substantially performed by employee-owners.
Articles of Incorporation

Kansas law requires that every corporation, upon formation, must file articles of incorporation with the Secretary of State. If the Secretary of State finds the articles of incorporation conform to the law, they will be filed accordingly. A copy of the articles of incorporation must also be filed with the Register of Deeds in the county of the main office of the corporation.

The articles of incorporation must include the following:

1. The name of the corporation.
2. The address, which includes the street, number, city and county of the corporation’s registered office in this state.
3. The nature of business the corporation plans to conduct.
4. The total number of shares of stock the corporation shall have authority to issue and the par value of each share. If more than one class of stock is to be issued, the articles should state the number of each class of stock that will be issued and the par value, if any, of each class of stock. Articles of incorporation also will specify each class of stock and any powers or restrictions placed on each class of stock.
5. The name and mailing address of the incorporator(s).
6. The names and addresses of people who are to serve as directors until the first annual meeting of stockholders or until successors are elected to qualify.

In addition to the above requirements, the articles of incorporation, may also include any or all of the following:

1. Any provision for management of the business or for the conduct of the affairs of the corporation.
2. A provision to regulate or define the way in which stock will be disposed of or exchanged.
3. A provision which grants or restricts the preemptive right to subscribe to any or all additional issues of stock.
4. A provision setting majority vote requirements higher than is stated by law.
5. A provision that would limit the duration of the corporation.
6. A provision stating that stockholders shall not be personally liable for the payment of the corporation’s debts except for reasons directly related to stockholder’s conduct or acts.
7. The manner of adoption, alteration and repeal of bylaws.
8. A provision which eliminates or limits the personal liability of a director to the corporation or its stockholders.

A filing fee is charged for filing articles of incorporation. It is suggested that the articles be kept as simple as possible because additional charges will be incurred should the articles of incorporation need to be amended. It is recommended that the bylaws be written to address the concerns of managing the corporation because bylaws are more easily amended or changed.

There are general procedures that need to be followed should the board of directors decide to amend the articles of incorporation. Once directors have adopted a resolution that states the proposed amendment, it must be submitted to the shareholders for a vote. Notice of the proposed amendment, along with the time and place of the meeting where the vote will take place, must be given to the shareholders. If the amendment is accepted by a majority of shareholders, the amendment can be presented to the Secretary of State. If the Secretary of State finds the amendment conforms to the law, it will be filed accordingly.

The requirements for the articles of incorporation of a business wishing to form a closely held corporation differ slightly from that of a publicly held corporation. They must state that:

1. The corporation will be closely held.
2. All the corporation’s issued stock of all classes, exclusive of treasury shares, shall be held of record by not more than a specified number of people, not to exceed 30.
3. All of the issued stock of all classes shall be subject to one or more of the restrictions on transfer permitted by Kansas law.
4. The corporation shall make no offering of any of its stock of any class that would constitute a “public offering” within the meaning of the United States Securities Act of 1933.

For purposes of determining the number of holders of record for the stock of a closely held corporation, stock that is held in joint or common tenancy or by the entirety shall be treated as held by one stockholder.

Corporate Bylaws

Each corporation has the right to draft a set of bylaws to govern its day-to-day actions. Corporate bylaws are intended to supplement the articles of incorporation. There is no legal form in which bylaws must be drafted, but the advice of an attorney is usually helpful. Bylaws do not have to be filed with the Secretary of State, but articles of incorporation do, which is the reason for keeping the articles as general as possible. If bylaws are used to govern the lesser general aspects of the corporation, stockholders-owners are able to make changes in the laws set forth to govern the corporation, should the need arise, without amending the articles of incorporation.

Bylaws may contain any provision that is not in conflict with the law or that is consistent with the articles of incorporation. Bylaws address issues relating to the business of the corporation, the conduct of its affairs, its rights or powers, and the rights or powers of its stockholders, directors, officers or employees.

There are no specific legal matters that have to be addressed in the bylaws, but most include provisions that regulate setting the time and place of the board meetings, the election of the board of directors and officers, board size, quorum size, duties of the directors and officers, and if not included in the articles of incorporation, requirements for amending the bylaws.

Domestic for-profit corporations also have to file annual reports and pay franchise taxes. The annual report must be filed with the Secretary of State and show the corporation’s financial condition at the close of business on the last day of its tax period. If the corporation’s tax period is something
other than a calendar year, it must give notice, in writing, of its different tax period to the Secretary of State prior to December 31 of the year it commences the different tax period. The annual report will be filed at the time of filing the corporation’s annual Kansas income tax return. If the corporation files for an extension on its income tax, it can also file for an extension on filing its annual report.

The Secretary of State has a prescribed form that corporations will use for its annual reports. The report must contain the following:
1. The name of the corporation.
2. The location of the principal office.
3. The names of the president, secretary, treasurer and members of the board of directors, with the residence address of each.
4. The number of shares of capital stock issued, and the amount of capital stock paid up.
5. The nature and kind of business in which the corporation is engaged.
6. A complete and detailed statement of the assets, liabilities and net worth of the corporation.
7. A list of stockholders owning at least 5 percent of the corporation’s capital stock, post office addresses and number of shares held by each.

Corporations holding agricultural land are also required to show the following information on their annual reports:
1. The acreage and location listed by section, range, township and county of each lot, tract or parcel of agricultural land in the state owned or leased by or to the corporation.
2. The purposes for which such agricultural land is owned or leased and, if leased, to whom such agricultural land is leased.
3. The value of the nonagricultural assets and the agricultural assets, stated separately, owned and controlled by the corporation both within and without the state of Kansas and where the assets are located.
4. The total number of stockholders of the corporation.
5. The number of acres owned or operated by the corporation, the number of acres leased by the corporation and the number of acres leased to the corporation.
6. The number of acres of agricultural land, held and reported in each category under provision (5), stated separately, being irrigated.
7. Whether any of the agricultural land held and reported under this subsection was acquired after July 1, 1981.

The annual report must be signed by the president, secretary, treasurer or other officer duly authorized to do so, or by any two of the directors, or by an incorporator in the event the board of directors shall not have been elected. At the time of filing, the corporation will have to pay the Secretary of State an annual franchise tax. The franchise tax will be at a rate of $1 for each $1,000 of the corporation’s shareholder’s equity attributable to Kansas. The limits set on this tax are such that the tax shall not be less than $20 and not more than $2,500.

If a corporation fails to file its annual report or pay its franchise tax within 90 days of the time for filing and paying the same, it is subject to forfeiture of its articles of incorporation. The corporation will also be held responsible for any additional penalties associated with such failure. The Secretary of State will give notice, by mail, within 60 days after the date when the annual report and taxes are due notifying any corporation that has failed to submit its annual report and/or pay its franchise tax that its articles of incorporation shall be forfeited unless the annual report is filed and the taxes are paid within 90 days of when they were due. If a corporation fails to file the report and pay its franchise taxes within this time frame, it will receive notice from the attorney general that the articles of incorporation have been forfeited.

3.14 Financing

A big advantage of the corporation business form is financing because of the large number of available sources. Perhaps the most widely used source of corporate funding is the use of securities. Securities, either debt or equity, are investments in the corporation.

Debt securities include loans or bonds issued by the corporation to purchase assets. Debt securities have the highest priority of all securities, in that they must be paid before any type of equity stock receives dividends. In case of liquidation or termination, debt securities are settled first.

Equity securities are issues of stock or shares in a company. When a person purchases a share of stock in a company, they take ownership in that company. Corporations can issue different classes of stock in order to differentiate between levels of ownership. Four of the most issued classes of stock are (1) common voting stock, (2) common nonvoting stock, (3) preferred voting stock, and (4) preferred nonvoting stock.

Common voting stock is the most universal type issued by corporations, because they must have at least one class of stock with unlimited voting privileges. Common stock is junior subordinated to other more senior securities such as preferred stock. Junior subordinated means that higher subordinated senior securities will receive dividends or payment before common stock.

Benefits to owning common stock are: (1) Common stockholders usually have the most power in the corporate structure. (2) They also will receive the highest dividends when the company is most profitable. This contrasts with preferred stockholders, which have a set dividend level. Common stockholders are investors with the most risk and potentially receive the highest payoff.

To further differentiate between common stock, several different series of stock may be issued. Each series can have different rights associated with it or can be tied to an individual profit group within the corporation.

As mentioned earlier, preferred stock is senior to common stock. However, preferred stock has no inherent rights except those specifically stated in the prospectus or on the stock certificates. Preference is usually given preferred stock to receive a specified dividend, regardless of profit
level, before dividends are paid to junior securities such as common stock.

In the case of liquidation or bankruptcy, common stockholders will typically receive the residual after all debts are paid and all preferred stockholders have received their settlement.

This illustrates briefly the flexibility that corporations have in their equity securities. They are free to issue several different classes and series of stocks to customize their equity make-up.

3.15 Management

The three basic groups involved in the management of a corporation are the stockholders, the directors and the officers.

Individuals or other entities can become stockholders in a corporation by buying stock in that corporation with money, property or services; or stock may be given to the stockholder. Stockholders who possess voting stock elect the board of directors. Thus, stockholders possess the ultimate power in a corporation.

The board of directors is made up of individuals elected by stockholders and shall consist of one or more members. The number of directors shall be fixed in the bylaws, unless set forth in the articles of incorporation. Directors have the responsibility of setting goals, general policies and directions for the corporation. In addition, the board of directors usually has the authority to declare dividends, formulate policy and authorize contracts involving the corporation.

The officers are responsible for carrying out the corporation’s business. They are usually corporate employees, although it is not mandatory.

The corporate structure is one of the best ways to manage a large business that has many owners (shareholders). Corporations centralize management in a board of directors. By doing so, a corporation is able to select experts in their fields of business to oversee the day-to-day operations of the officers and employees of the corporation.

There are no formal requirements that board members be shareholders, although corporations are free to set requirements for the board of directors in their bylaws. This is an advantage because experts may be elected to the board who do not necessarily own stock in the company.

Officers and employees are responsible for performing the day-to-day operations of the corporation. They have the responsibility of carrying out the initiatives set forth by the board of directors. Officers shall be selected in a manner described in the bylaws. The number of officers who will be appointed and their term of office will also be prescribed in the bylaws. No formal guidelines exist about the title or appointment and their term of office will also be prescribed in the bylaws. No formal guidelines exist about the title or

3.16 Life of the Business

A corporation is viewed legally as an entity in itself, separate from its stockholders. The death or insolvency of a shareholder does not end the life of the corporation. Shares of stock can also be sold or given to new owners without affecting the operations of the corporation.

Continuity of life and free transferability of interest make the corporate business form one of the most widely used. Continuity of business life is especially important to a business that has developed a highly recognized and marketable name. As ownership changes, the business continues to function independently.

3.2 S CORPORATION (SC) DEFINITION

An SC is also known as a tax option corporation or a small business corporation. A corporation must make an election to be taxed as an SC, and all shareholders must consent. An SC is a separate legal entity and is a nontaxable entity like a partnership. The SC is a hybrid of a partnership and a CC. The SC combines some of the most appealing advantages of a partnership with many of the advantages of a CC. Some of the basic characteristics of SCs follow.

An SC has the pass-through tax advantages of a partnership with the limited liability of a CC. Although an SC has the limited liability of a CC, it has additional restrictions placed on it when compared to CCs. SCs have restrictions on the number of shareholders and types of stocks that can be issued. The subchapter S Revision Act of 1982 made major revisions and changes in subchapter S, but many restrictions and requirements remain.

3.21 Liability

SCs have the same limited liability benefits for shareholders as CCs. Shareholders risk only the amount invested in the company. Although corporations shelter shareholders from personal liability as a rule, some of the limited liability insulation will be removed if creditors require shareholders to guarantee any loan or lease. However, shareholders would still, for the most part, be protected from personal liability for acts arising in the ordinary course of the corporation’s business.

3.22 Taxation

The motivating incentive for making an S election is for tax purposes. An SC can take advantage of the pass-through tax treatments of a partnership and combine them with the limited liability of a corporation. As stated earlier, there are restrictions placed on corporations choosing to make the S election.

An SC is generally exempt from paying federal income taxes. Instead of paying federal income taxes at the corporate level, income is passed through to shareholders
and taxed at their marginal rates. This can be advantageous if the shareholder’s marginal tax rate is lower than the corporate rate.

Although an SC’s income is taxed at the shareholder level, it may be subject to one or more of the following corporate-level taxes:

1. Tax on recognized built-in gains.
2. Tax on excess net passive income.
3. Tax on capital gains attributable to certain substituted basis property, if the S election was made before 1987.
4. Tax on recapture of investment credit.

An SC figures its taxable income much the same as an individual, with a few exceptions. Items of income, loss, deduction or credit must be separately stated if their separate treatment by a shareholder could affect his/her tax liability. Although an SC’s taxable income is computed in the same manner as an individual’s, the corporation may not take the following deductions allowed to individuals:

1. Personal exemptions.
2. Foreign taxes.
3. Charitable contributions.
5. Additional itemized deductions.
6. Oil and gas depletion.

Since SCs are taxed through an individual shareholder’s personal income tax, the marginal rates are the appropriate rate for each shareholder.

Like all other for-profit businesses, SCs in Kansas have to pay state income taxes as well as federal taxes. Not all states tax SCs as partnerships. A limited number of states do not recognize SCs as partnerships for tax purposes and tax them as regular corporations for the state portion of their income tax. However, Kansas recognizes SCs as a business form and taxes them as a partnership. Kansas also allows credits for taxes paid to another state, whether shareholders paid the foreign tax or the corporation paid it.

SCs are taxed at the shareholder level. Losses, especially during the start-up period of many new businesses, are passed through to the shareholders if they are active participants. If the shareholders are not active participants, losses will be considered passive losses, deductible only against passive gains.

Another tax advantage of an SC is the deductibility of interest expenses incurred by the shareholders in the corporation. This interest is generally treated as fully deductible business interest if the shareholder materially participates. If the shareholder does not materially participate in the corporation, such interest is a component of passive income/loss. This differs from CCs in which, even if the shareholder materially participates, such interest is investment interest to the extent the assets are portfolio assets and are not deductible.

Other tax advantages include the following:

1. It avoids the risk of the accumulated earnings tax. But SCs are subject to limits on passive income if they have earnings and profit from prior CC years.
2. It minimizes the risk the IRS will rule unreasonable compensation for excessively high salaries.
3. It avoids the personal holding company tax.
4. It avoids the 34 percent flat tax imposed on personal service corporations.

Although an SC has many tax advantages that at first make it an appealing alternative, it has many disadvantages. Some of the basic disadvantages follow.

Shareholders are taxed on reinvested earnings. An SC that reinvests earnings into the business puts the tax liability for all income on the shareholders. The result from such actions can put large tax obligations on the shareholders, who will have no cash flow from the reinvested portion of the business’s profits. This can especially be a problem for a business with low profits. This is one reason why all shareholders must consent to the election of an SC.

Low income businesses lose the lower corporate tax rate. An SC with low earnings will not be able to take advantage of the lower corporate tax rate of 15 percent on the first $50,000, compared to the 15 and 28 percent marginal rate for individuals. SCs are more beneficial for businesses with higher income levels of $75,000 and over where the corporate tax rate is higher than the individual marginal rate.

3.23 Legal Filing Formalities

The incorporation process is identical to that for a CC, except that an election of a SC must be made. Like CCs, articles of incorporation and bylaws must be filed with the appropriate state offices.

**SC Eligibility Requirements**

To be eligible for SC status, a business (1) must be small (fewer than 35 shareholders), (2) must be a domestic corporation (formed within the United States), (3) may not have more than one class of stock (although differences in voting rights are permissible), (4) may not be a member of an affiliated group, (5) may not have nonresident alien shareholders and (6) must not be an “ineligible corporation.” A more detailed discussion of each of these eligibility requirements follows.

A corporation that wants to elect SC status may not have more than 35 shareholders. A husband and wife, and their estate, are considered as one shareholder regardless of whether the stock is owned by them as separate individuals or as co-owners, except in the case of a divorce when both retain ownership of stock. At that point, they will be counted as two stockholders. Estates are counted as single shareholders as long as the stock remains part of the estate. Once the stock is distributed to the beneficiaries, each beneficiary receiving stock will be counted as a shareholder. People who are not husband and wife who own stock jointly are considered as separate shareholders. A word of caution: Partnerships that own stock in a corporation will not be viewed as separate individuals but as a partnership precluding an election under S because partnerships are not eligible shareholders.

The limited shareholder problem has been a major disadvantage of the SC, at least for many potential businesses that would possibly choose an SC as a business form. A recent IRS ruling may alleviate some of this problem by allowing an eligible number of shareholders to
form multiple SCs that would in turn form one partnership to conduct one business. Revenue Ruling 94-43 would allow SCs that operate together through a partnership to be governed similar to limited liability companies.

The list of eligible shareholders for SCs is limited. To qualify as an SC, all shareholders of a company must fall under these categories: (1) individual, (2) estate or (3) certain types of trusts.

Estates of minors, incompetents and people under a disability are all permitted to be shareholders of SCs. The estate of a deceased shareholder and the estate of a bankrupt individual are also eligible shareholders.

Many restrictions are placed on the eligibility of trusts as eligible shareholders in a SC. A list of eligible trusts follows:

1. Voting trusts, which are trusts created primarily to exercise the voting power of the owned stock.
2. Grantor trusts, which are trusts in which all income and corpus is treated as being owned by one individual who is a U.S. citizen or resident.
3. Trusts in existence before death that met the requirements of a grantor trust and that continue in existence after death, although eligibility is limited to a maximum two-year period of ownership.
4. Testamentary trusts, which are trusts that receive S stock pursuant to the terms of a will. Generally, eligibility is limited to a 60-day period of ownership.
5. Qualified Subchapter S Trusts (QSST), which are trusts that own stock in one or more SCs and are treated as trusts as described by the grantor trust above. The IRS has released several revenue rulings that clarify the requirements for QSST status. The following is a list of those requirements:
   a. The beneficiary must elect QSST status.
   b. There is only one income beneficiary of the trust during the life of the current income beneficiary, and that beneficiary must be a U.S. citizen or resident.
   c. All income of the trust is, or is required to be, distributed currently to the one income beneficiary.
   d. Any corpus distributions that might occur must also go to that one beneficiary, if made during the beneficiary’s lifetime.
   e. The income interest of the beneficiary must terminate on the earlier of the beneficiary’s death or the trust’s termination.
   f. An election to be treated as an eligible SC shareholder must be made separately for the stock of each SC held by the trust.
   g. A new (successor) income beneficiary does not have to file an election to continue QSST status. The beneficiary may refuse to consent to the QSST election, which would invalidate the QSST election and thereby revoke the S election.

SCs are also restricted to one class of stock. Only classes of stock that are issued and outstanding will be counted in determining the number of classes of stock. This being the case, treasury stock or authorized but unissued stock of a second class of stock does not disqualify the corporation.

Statutes do not give a definition of “class of stock,” but regulations state that if the outstanding shares “are not identical with respect to the rights and interests whom they convey in the control, profits, and assets of the corporation,” the corporation is considered to have more than one class of stock. Simply having differences in voting rights among a single class of common stock does not constitute a second class of stock.

For a long time, there were many questions about how the IRS would view debt obligations. Over the years, many court decisions and tax laws have been made, and the distinction between debt that will be classified as a second class of stock and that which will not is starting to become somewhat easier to determine. IRC Section 1361 (c)(5) was enacted in 1982 to create a safe harbor for “straight debt,” which is defined as any written unconditional promise to pay a sum certain in money either on demand or on a specified date, provided that:

1. The interest rate and payment dates are not contingent on profits, the borrower’s discretion or similar factors.
2. The obligation is not convertible directly or indirectly into stock.
3. The creditor is an individual (other than a nonresident alien), an estate or a trust qualified to be a shareholder of a SC. Even if debt meeting these conditions is treated as equity for other purposes, it is not treated as a second class of stock in applying Section 1361(b)(1)(D).

The previous paragraphs outlined the safe harbor available for debt issued prior to May 28, 1992. Obligations issued on or after May 28, 1992, will not be treated as a second class of stock under the following circumstances:

1. Unwritten advances from a shareholder to the corporation that in total do not exceed $10,000 at any time during the corporation’s tax year are treated as debt by the parties and are expected to be repaid within a reasonable period of time.
2. Obligations that are owned solely by shareholders and in the same proportion as the outstanding stock of the corporation.
3. “Straight debt,” as described in the previous paragraph.

Some corporations are ruled ineligible to make an S election. If a corporation is an “affiliated group,” as defined by Section 1504, relating to consolidated returns, it is an ineligible corporation. An affiliated group is where there is at least 80 percent ownership of a subsidiary. In applying the 80 percent ownership test, only direct stock ownership is taken into consideration. In such a case, an SC can own 79 percent of a subsidiary’s outstanding stock, with the remaining 21 percent owned by the SC’s shareholders. In this situation, the same people own the entire amount of outstanding stock of a subsidiary, but the SC directly owns less than the maximum permitted 80 percent.

In addition to affiliated groups, four other classes of corporations are also ineligible to make elections under S:

1. Insurance companies, generally, other than certain casualty insurance companies.
2. Financial institutions, relating primarily to banks, that are allowed a bad debt deduction under Internal Revenue Code (IRC) Sections 585 or 593.
3. Former or current domestic internal sale corporations.
4. Corporations, electing under IRC Section 936, allowing credits for certain income from Puerto Rico and U.S. possessions.

**Making an SC Election**

If a corporation meets the eligibility requirements for becoming an SC, it can make an election on or before the 15th day of the third month of the taxable year. If a corporation were operating under a calendar year, that date would be March 15. Any election made after the 15th day of the third month of the taxable year will not take effect until the next taxable year.

An IRS Form 2553, Election by a Small Business Corporation, must be signed by a person authorized to sign the corporation’s tax return and filed with the IRS. Along with that signature, Form 2553 must also include the following:

1. The name of each shareholder.
2. The number of shares each shareholder owns and the dates acquired.
3. The Social Security numbers of all shareholders.
4. The shareholders’ tax year-ends, month and day.

Signatures on an S election are required from an officer on behalf of the corporation and from each shareholder consenting to the corporate election.

The decision to make an S election must be unanimous. For this reason it is best to get the election signed as soon as possible after making the decision to elect in order to avoid the possibility of shareholders changing their minds and deciding against the election.

**Termination of an S Election**

A revocation, or voluntary termination, can be accomplished only if shareholders holding more than 50 percent of the corporation’s outstanding stock on the day of the revocation agree. A revocation can be retroactive to the beginning of the taxable year, if it is made on or before the 15th day of the third month of the taxable year. If it is made after this date, the corporation can specify the date the revocation is to take place. It can choose to have it take effect immediately, at the beginning of the next taxable year, or any date in between.

Closely held corporations that used an S election in the low profit start-up years to pass losses through to shareholders often file a revocation. After the corporation starts to generate income, shareholders often decide to terminate the S election if they do not want to report the profits on their personal income tax returns.

A corporation’s S election can be terminated involuntarily. Violation of any of the qualifications of an S election will terminate the election. Although this is an involuntary termination of the election, actions that caused the termination may have been intentional. An example of such a situation is that a corporation may decide to have more than 35 shareholders or issue more than one class of stock. Both of these events would “involuntarily” terminate the S election, but the corporation may have “voluntarily” decided to do so.

S elections also can be involuntarily terminated due to excessive passive income. If an SC receives more than 25 percent of its gross receipts through passive sources in three consecutive years, and if it has CC accumulated earnings and profits at the end of each year, the S election terminates as of the beginning of the first year following the end of the three-year period.

**New Election After Termination**

Generally, there is a five-year waiting period for a re-election after a termination. The five-year period is effective for both voluntary and involuntary termination. The five-year waiting period may be shortened by the IRS under Section 1362 (g). Events that may persuade the IRS to shorten the waiting period include the following:

1. A transfer of more than 50 percent of the stock to new shareholders.
2. Termination was the result of actions not reasonably within the control of the corporation or the shareholders with substantial interest in the corporation. An example of such event is the sale of stock to a nonresident alien by a minority shareholder in an attempt to get shareholders to buy him out.
3. Excess passive gross receipts as the result of a depressed economy. Although the IRS has the power to shorten the waiting period, the burden of persuasion rests on the corporation.

**3.24 Financing**

SCs can be financed in much the same way as a CC by selling shares of stock in the company or issuing debt securities. However, unlike a CC, SCs can issue only one class of stock. This fact can make financing SCs somewhat more difficult than for CCs. Also, as mentioned before, the number of shareholders is limited to 35.

**3.25 Management**

SCs are managed the same as CCs. Differences between SCs and CCs are in the way the business and its owners are taxed. For a review of how corporations can be managed, refer to the management section in chapter 2.

**3.26 Life of the Business**

All SCs and CCs are viewed legally as individual entities, separate from their stockholders. The death or insolvency of a shareholder does not end the life of the business, which is the case with a SP or partnership. Shares of stock can be sold or given to new owners without affecting operation of the corporation.

Continuity of life and free transferability of interest make the corporate business form one of the most widely used forms of business. Continuity of business life is especially important to a business that has developed a highly recognized and marketable name. As ownership changes, the business continues to function independently from the owners.
CHAPTER 4: LIMITED LIABILITY COMPANIES

4.1 LIMITED LIABILITY COMPANY (LLC) DEFINITION

A LLC is one of the newest forms of business and has been labeled as the “business entity of choice.” The State of Kansas adopted a comprehensive set of LLC statutes in 1990. An LLC is a unique business form that combines the tax advantages of a partnership with the limited liability of a corporation. It shares these advantages with a SC, but does not have many of the disadvantages of SCs. A properly structured Kansas LLC is a separate legal entity but is not considered a corporation.

A LLC may be formed by any person but must include two or more members. To form a LLC, articles of organization for the LLC must be filed with the Secretary of State. Rights provided to LLCs include: (1) An LLC may conduct or promote any lawful business or purpose that a partnership or individual may conduct or promote. (2) LLCs can own property, borrow money, loan money, enter into contracts, and elect or appoint managers and agents of the LLC.

A variation of a LLC is a limited liability agricultural company (LLAC). Kansas law permits the creation of LLACs for the purpose of operating swine or dairy production facilities in counties in which voters either have failed to adopt or have rejected corporate swine or dairy production facilities.

LLACs have a few restrictions that are not placed on regular LLCs. Membership is limited to 10 all-natural people (noncorporations) acting in a fiduciary capacity for a natural person or nonprofit corporation or GPs other than corporate partnerships formed under Kansas laws. LLACs are required to have at least one member residing on the farm or be actively engaged in the labor or management of the farming operation. Although, if only one member of the LLAC meets the requirements of this provision and he or she dies, the requirement of this provision does not apply for the period of time that the member’s estate is being administered in any district court in Kansas.

4.2 FACTORS OF SELECTION

4.21 Liability

An advantage of LLCs are that members of a properly organized LLC receive limited personal liability from business activities. Members are not personally liable for debts or obligations incurred by the business and are at risk only for the amount they have invested in the LLC.

4.22 Taxation

One of the important advantages of a LLC is the pass-through tax advantage of partnerships. The key to getting this favorable tax status is in the structure of the LLC. The IRS will tax an LLC as a corporation if it has more than two corporate characteristics. The determining corporate characteristics are (1) limited liability, (2) continuity of life, (3) free transferability of interests and (4) centralized management.

Since one of the main objectives of forming an LLC is to achieve limited liability with the pass-through tax advantages of a partnership, limited liability is almost always a characteristic of a LLC. If the limited liability characteristic is present, there can be only one more of the three remaining corporate characteristics present to maintain the noncorporate tax treatment.

The IRS analyzes whether or not an LLC actually possesses limited liability when making the determination if the business has the corporate characteristic of limited liability. An LLC can be ruled to not have the corporate characteristic of limited liability if it is formed in a state that allows the members to waive their personal liability and does so in its articles of organization.

It can be difficult to organize an LLC without having the corporate characteristic of limited liability. Furthermore, it is unusual to organize a business as an LLC without having limited liability as an objective.

With this in mind, it is important to consider the remaining three corporate characteristics of continuity of life, free transferability of interests and centralized management. These three will typically be the deciding factors in the determination of how the IRS will rule on the business for tax purposes. It all hinges on the particular state LLC Act and whether the IRS has accepted it. Also, the LLC must be organized in accordance with the statute.

Continuity of life is a distinguishable characteristic of a corporation, but can also be accomplished with an LLC. If a shareholder of a corporation dies or sells his/her stock in the business, the business continues operating. In contrast, any changes in a partnership group cause a technical dissolution, but not necessarily liquidation, of the partnership business. If an LLC is to exist without the corporate characteristic of continuity of life, the LLC’s articles of organization or operating agreement must mandate that it be dissolved upon the death, resignation, expulsion, bankruptcy or dissolution of a member, or for any other reason that would terminate a member’s interest in the LLC. If an LLC should lose a member for any reason, the remaining members must agree to continue the business. This allows the LLC to operate without the corporate characteristic of continuity of life.

Free transferability of interests is also a corporate characteristic. Shares of corporate stock are freely transferable with little or no effect on the daily operation of the business. This is an advantage for investors who wish to take advantage of corporations with growth potential and for companies that are trying to finance their businesses.

Free transferability of interests is lacking if the LLC’s articles of organization or operating agreement provide that the assignee or transferee of a member’s interest does not acquire all of the attributes of the transferor member’s interest without the consent of the remaining members’ holding a majority interest in the LLC, its capital interest or profits.
The Kansas LLC Act is written to prevent LLCs from having free transferability of interests. Under this law, there will always be restrictions on the transfer of interests of LLCs, regardless of items set forth in the articles of organization or operating agreement. Therefore, even if members wish to write free transferability into their articles of organization or operating agreement, they cannot, because Kansas law has precedence.

Amendments to the Kansas Limited Liability Act in 1994 and 1995 allow approval of transfer of a member’s interest in the LLC with approval by a majority of the nontransferring members, rather than unanimous approval, and allows for the continuation of the LLC after the dissolution or death of any member, with approval of a majority in interest of remaining members.

The 1995 amendments also allowed partnerships and other entities to convert to an LLC and allow mergers or consolidations of LLCs.

Centralized management is another characteristic common to most corporations. The majority of investors in a corporation know little about the day-to-day operations of the business. Shareholders have little managerial power over business activities. Corporate management is usually centralized in a board of directors and officers.

In contrast, the partners usually decide management of a partnership. General partners are usually responsible for managing the business. Limited partners must refrain from participating in management of the business in order to receive the protection of limited liability.

LLCs are free to choose whether they want centralized management or whether they wish members to be managers. Members can set forth in the articles of organization or operating agreement methods of management selection. If they choose to have a manager, who may or may not be a member, the responsibilities for that position must be set forth in the articles of organization or the operating statement.

Once again, if an LLC wishes to have centralized management, organizers need to be careful that it has no more than one more corporate characteristic in order to receive tax treatment of a partnership. If the LLC has more than two corporate characteristics, it will be taxed as a corporation.

The process of forming an LLC can be complicated. Organizers must know what business structure they want and whether the LLC will provide it. Most organizers want the pass-through benefits of a partnership with the limited liability of a corporation. With this in mind, organizers generally opt for limited liability of members, which leaves only one other corporate characteristic that the business can possess and still receive the tax treatment of a partnership. Kansas law restricts the transferability of interests, so organizers need to decide if they want the business to have centralized management or continuity of life. Organizers need to determine what would be best for the business situation. Although the IRS allows the LLC to have two corporate characteristics and still be taxed as a partnership, there is no requirement to have any of them. If organizers choose only the corporate characteristic of limited liability, the organization would not be ruled a corporation by the IRS.

In 1994 the IRS ruled in favor of the Kansas LLC Act. It ruled that an LLC organized with no more than two of the four corporate characteristics – limited liability, free transferability of interest, continuity of life and centralized management – would be taxed as a partnership. Although the IRS has ruled on the Kansas LLC Act, an attorney or tax advisor should be consulted early in the business formation process.

As discussed earlier, LLCs can be taxed as partnerships or SCs. Ideally, the LLC will be treated as a partnership for tax purposes. If so, the members of the LLC will be able to take advantage of the pass-through tax treatment of a partnership.

Methods of accounting and taxable year are important tax issues to consider when choosing a business form. LLCs may generally use the cash method of accounting, but one disadvantage of LLCs is the poor flexibility in establishing a taxable year. Most LLCs use the calendar year as a taxable year if members are mostly natural people. The LLC will probably have a December 31 fiscal year-end. This can be a disadvantage to businesses that have high revenue periods at the end of a calendar year. In this situation, there is usually inadequate time to make adjustments in deductible spending to adequately adjust taxable income. But, 26 U.S.C. § 706(b), Reg. 1.706 requires that LLCs must adopt the fiscal year that affords the minimum deferral for tax purposes. The rules can become very complicated, but generally stated, the LLC multiplies the number of months until the fiscal year-end of each member times that member’s percentage of ownership interest in the LLC. These products are then added for each fiscal year-end, and the LLC must use the member’s fiscal year-end that results in the lowest total or “least aggregate deferral.” This situation could arise when corporations with noncalendar year-end fiscal year-ends become members of a LLC.

Members of a well-organized LLC will pay for any LLC tax liabilities through personal income tax returns.

Another aspect of income taxes is state income taxes. With the relative newness of LLCs, many states are unsure in how they will be taxed. It is important to check state laws governing the treatment of LLCs for tax purposes. There is a possibility for situations similar to those where SCs are taxed by some states as CCs and not partnerships. Each state’s tax laws are set individually, so consult your tax advisor to determine your state’s tax laws governing LLCs.

In Kansas, LLCs are taxed as partnerships if they meet the federal guidelines set forth for rulings to determine the status of LLCs for tax purposes.

Unlike CCs, state taxes on LLCs are not deductible from federal income taxes. This is an important factor when evaluating differences in tax liabilities. CCs are generally allowed to deduct state taxes, which, for businesses in high tax brackets, can account for sizable amounts.

Another aspect is that of the self-employment tax consideration. If a LLC is taxed as a partnership, the same
self-employment tax considerations apply as those found in partnerships. Of that amount, one-half is deductible from taxable income from the taxable year within which it was paid.

4.23 Legal Filing Formalities

Limited liability companies have a complex legal formation process. Many similar processes must be undertaken to form a LLC as to form a corporation. As always, consult an attorney when you formally organize a LLC.

Articles of Organization

Kansas state law requires that any business forming as a LLC must file articles of organization with the Secretary of State. The original signed copy and a duplicate copy need to be filed with the Secretary of State. Once the articles are filed and filing fees are paid, the LLC shall be considered organized.

Articles of organization for an LLC must include the following:

1. The name of the LLC, which will include the words “limited company” or “LLC” or their abbreviations “L.C.” or “L.L.C.” The name must be one that distinguishes it from all other businesses registered with the Secretary of State.
2. The period of its duration.
3. The purpose for which the LLC was formed.
4. The address of its registered office in the state and the name and address of its initial resident agent in the state.
5. The right, if given, of the members to admit additional members and the procedures for doing so.
6. The right, if given, of the remaining members to continue doing business should, for any reason, a member of the LLC terminate the continued membership of the LLC.
7. If the LLC is to be managed by a manager or managers or by members, it will be stated, and the names and addresses of such managers who are to serve as managers until their successors are elected and qualify will be listed; or if the LLC will be managed by its members, the names and addresses of the members will be listed.
8. Any other provisions, which are consistent with the law, that the members elect to set out in the articles of organization for the regulation of the internal affairs of the LLC. It is not necessary to set out in the articles of organization any of the powers enumerated in the Kansas LLC Act.

Articles of organization for an LLC are required by Kansas law to be amended should certain circumstances arise. Reasons for amending articles of organization:

1. If the name of the LLC is changed.
2. If a substantial change has occurred in the character of the business of the LLC.
3. If a false or erroneous statement appears in the articles of organization.
4. If the time set in the articles of organization for dissolution of the LLC has changed.
5. If the members desire to make a change in the articles of organization so that the articles accurately represent the agreement among them.
6. If management has been vested in a member who becomes disassociated with the LLC or if new managers are chosen.

Once the articles of organization are amended, all members must sign the certificate of amendment. If the amendment is adding a new member(s), the new member(s) must sign it. After being signed by all members, the amendment is sent to the Secretary of State’s office where, if it is found to not be in conflict with the law, it will be filed accordingly. Once filed and the fee paid, the amended articles will be considered in effect.

Operating Agreement

An operating agreement for an LLC is much like the bylaws of a corporation (Chapter 3). The operating agreement sets forth guidelines for situations that are not included in the articles of organization. The operating agreement must be approved and signed by all the members of the LLC before it becomes binding.

An operating agreement may govern the rights, duties and obligations of members and managers, if the members desire to set such guidelines. Any provisions for the regulation and management of the affairs of the LLC that are not inconsistent with the law or articles of organization may be included in the operating agreement.

These items should be included in the operating agreement:

1. Location of the principal office.
2. Time and place of meetings of managers or members.
3. Guidelines that must be met to call special meetings.
4. Any requirements on the number of members present to constitute a quorum for the transaction of business.
5. Any restrictions or guidelines for the transferability of a member’s interest.
6. Any requirements for amending the operating agreement.

Annual Report

Every LLC, foreign (organized in another state) or domestic, is required to file an annual report with the Secretary of State showing its financial condition at the close of business on the last day of its tax period. If the foreign LLC’s tax period is other than a calendar year, it must give notice, in writing, of its different tax period to the Secretary of State prior to December 31 of the year it commences the different tax period.

The Secretary of State has a prescribed form that a LLC will use for its annual report. The report must contain the following:

1. The name of the LLC.
2. A reconciliation of the capital accounts for the preceding taxable year, as required to be reported on the federal partnership return of income.
3. A balance sheet showing the financial condition of the LLC at the close of business on the day of its tax period next preceding the date of filing.
The annual report must be signed by a member of the LLC and forwarded to the Secretary of State. At the time of filing, the LLC will have to pay the Secretary of State an annual franchise tax. The franchise tax will be at a rate of $1 for each $1,000 of the net capital accounts located in or used in the state at the end of the preceding taxable year as required to be reported on the federal partnership return of income. The limits set on this tax are such that the tax shall not be less than $20 and not more than $2,500.

If a foreign LLC fails to file its annual report or pay its franchise tax within 90 days of when due, it is subject to forfeiture of its right or authority to do business in the state of Kansas. The LLC will be held responsible for any additional penalties associated with such failure. The Secretary of State will give notice, by mail, within 60 days after the date when the annual report and franchise taxes are due, notifying any foreign LLC that has failed to submit its annual report and/or pay its franchise tax that its authority to do business in the state of Kansas shall be forfeited unless the annual report is filed and the taxes paid within 90 days of when the annual report and franchise taxes were due. If a foreign LLC fails to file an annual report and pay its franchise taxes within this time frame, it will forfeit its authority to do business in the state, and the Secretary of State will publish a notice of the forfeiture in the Kansas register.

If a domestic LLC fails to file an annual report or pay its annual franchise fee within 90 days of when due, it is subject to forfeiture of its articles of organization. The procedures for doing so are the same as for a foreign LLC that fails to file its annual report and/or pay its franchise fees.

4.24 Financing

A LLC can be one of the least difficult forms of business to finance. LLCs are more easily financed than partnerships or proprietorships, but not as easy as financing a publicly traded corporation. LLCs can be financed by using a combination of debt and equity financing that members can acquire. Limited liability is the main advantage an LLC has over a partnership when financing a business. Investors are more likely to participate in the financing of a business if their liability is limited to the amount they have invested.

4.25 Management

A LLC has flexibility in the way it structures its management. The size of the business will have much to do with the decision of how management authority will be delegated. By law, the management of the LLC shall be vested in its members, with each member having one vote, unless otherwise provided in the articles of organization or the operating agreement.

Members are free to set a management structure that appoints the responsibility to one or more members who will be considered manager(s). Management may also be vested in an outside person hired solely for the purpose of managing the business. Any specifications on who will manage the business and how it will be managed must be set forth in the articles of organization or operating agreement. This option has never been available before. LPs prohibit limited partners from taking an active role in management.

Part of the managerial responsibilities for a LLC are filing an annual report and paying franchise taxes. Every LLC is required to make an annual report in writing to the Secretary of State, showing the financial condition of the LLC at the close of business on the last day of its tax period next preceding the date of filing. The annual report will be filed at the time of filing the LLC’s annual Kansas income tax return. If the LLC files for an extension on its income tax, it can file for an extension on filing its annual report.

The Secretary of State has a prescribed form that LLCs use for annual reports. The report must contain the following:

1. The name of the LLC.
2. A reconciliation of the capital accounts for the preceding taxable year as required to be reported on the federal partnership return of income.
3. A balance sheet showing the financial condition of the LLC at the close of business on the last day of its tax period next preceding the date of filing.

4.26 Life of the Business

The life of a LLC is somewhat unlimited. Kansas law states that the transfer of ownership within an LLC must be approved by a majority vote of the members. This process will allow the business to continue to function with the death of a member or if members should decide to sell their interests in the business.
5.1 COOPERATIVE DEFINITION

A cooperative is a unique type of corporation that is a user-owned and user-controlled business that distributes margins to users on the basis of use or patronage. The users are its customers or patrons eligible to (1) own stock or other forms of equity, (2) receive the benefits of a share of the net income or profits, usually as patronage refunds, and (3) control the co-op as a voting member. Co-ops are organized to conduct business-at-cost. The user-owned, user-controlled and user-benefit aspects of a cooperative are some of its distinguishable characteristics. The users of a cooperative achieve ownership by patronizing the business, and control of the co-op is associated with the voting power of its members.

Net income or savings, similar to profits, are distributed to members of a cooperative usually in the form of patronage refunds on a patronage basis. Although a cooperative is said to operate on an at cost basis, income must be generated and retained to finance the cooperative’s assets in order to serve its members on an ongoing basis. “Business-at-cost” is normally achieved at the end of the fiscal year by distributing patronage-based income as patronage refunds.

There are many different types of co-ops including agricultural co-ops and consumer co-ops. This chapter focuses on agricultural co-ops. Most states have specific laws applying to agricultural co-ops.

A cooperative has the power to engage in any activity in connection with the marketing, selling, harvesting, threshing, milling, preserving, drying, processing, canning, packing, storing, handling or utilizing any agricultural products produced or delivered to it by its members. In addition, it can engage in the manufacturing or marketing of the byproducts of any of the agricultural products of its members. A cooperative can also engage in any activity in connection with agricultural education, research, legislation, and economic and social conditions.

A cooperative is free to function as a general farm organization and to levy and collect dues from its members. It can borrow money, enter into contracts, purchase real estate, establish reserves, and invest such funds in physical facilities or in any way that the bylaws permit.

A cooperative is viewed as a separate entity formed for the mutual benefit of its patron-member-owners. Patrons of a co-op are its customers, most of whom are also voting members. When compared to investor-oriented firms such as CCs and SCs, the unique characteristic of a cooperative is that the owners of a cooperative are also the customers of the cooperative. This characteristic can cause some difficulty in operations when management has to try to satisfy owner-members of a cooperative as customers and as shareholders of the cooperative.

5.2 FACTORS OF SELECTION

5.21 Liability

Members of a cooperative are patrons and owners of a corporation and receive shelter from liability, as do shareholders of a regular corporation. Members are not personally liable for debts or obligations incurred by the cooperative. Members generally can lose only the amount they have invested in the cooperative.

5.22 Taxation

Co-ops are usually organized as corporations and they may be taxed like C corporations. However, they may be taxed like GPs, SCs and LLCs if they abide by the regulations found in subchapter T of the Internal Revenue Code. These regulations allow a pass-through of taxable income to users or patrons similar to the pass-through to owners in GPs, SCs and LLCs. Cooperatives that rely primarily on Subchapter T are referred to as “non-section 521” cooperatives. Any cooperative corporation or C corporation can choose to “operate on a cooperative basis”, as defined in Subchapter T, and utilize cooperative taxation provisions. Another taxation alternative is section 521. Subchapter T allows co-ops who qualify to utilize the provision of Section 521. Only cooperative corporations are allowed to utilize the provisions of Section 521. Truly, co-ops are unlike any other business form when it comes to tax issues.

Many terms are unique to cooperatives such as patron, nonpatron, allocated equity, unallocated equity, qualified patronage refund and nonqualified patronage refund. Cooperative accounting can become quite confusing, even to those who work with finance and accounting daily.

How a cooperative is taxed is based on whether or not it is distributing patronage refunds that are qualified or nonqualified. Taxes on qualified patronage refunds are paid by the patron, and the cooperative is free from any tax liabilities on that income. In other words, qualified patronage refunds are qualified as deductions from co-op taxable income.

Qualified patronage refunds must qualify in order to be a deduction from the cooperative’s taxable income. To be qualified, at least 20 percent of the refund must be in the form of cash, and the entire distribution must be made within 8.5 months after the close of the accounting year. The written notice will be in money, qualified written notice of allocation, or other property. The retained or deferred portion of the distribution, or the part not paid in cash, may be issued in the form of stock, stock credit, other equity instruments or equity capital book entries.

Taxes on qualified patronage refunds are paid by the patron or recipient. Although patrons only receive part of the refund in the form of cash, they must report the total amount of the refund on their income tax return. If the cash patronage portion is less than the marginal tax rate of the patron, the patron may claim patronage refunds cost him/her money. If a patron receives only 20 percent of the patronage...
refund as a cash patronage refund and is in a high income tax bracket, the tax liability will be higher than the cash refund.

Co-ops may also choose to use nonqualified patronage refund distributions. If they do so, there are no minimum requirements on the amount that must be paid in cash. The entire amount can be paid as a noncash refund. The cooperative will be taxed on the amount retained at the cooperative level at the ordinary corporate marginal tax rate. The individual still reports any cash patronage refund on his/her income tax return but does not report the noncash portion until the year in which the cooperative redeems that equity in cash. At that time the cooperative will have a tax deduction for the amount redeemed to the patron, and the patron will have taxable income in the amount received.

A pass-through single taxation still occurs due to the deduction received by the cooperative when the equity is redeemed to the patron in the form of cash. The two things to remember are (1) there is no double taxation of patronage refunds and (2) in the end the patron will pay the tax on the income distributed as patronage refunds.

A portion of a co-ops’ business is often conducted with nonmembers or nonpatrons. Since nonmembers are not eligible for a patronage refund, any margin made from doing business with nonmembers will be retained in the cooperative as unallocated retained earnings. The taxes on this income are paid at the cooperative level at the corporate tax rate. The exception to this would be for cooperatives that are Section 521 cooperatives, which is described next.

If the cooperative complies, Section 521 of the Internal Revenue Code allows agricultural cooperatives additional deductions from taxable income. Under Subchapter T, only Section 521 cooperatives can deduct from taxable income nonpatronage income distributed to patrons on a patronage basis and dividends on capital stock, in addition to qualified patronage refunds and per-unit capital retains.

The requirements for the special tax benefits of Section 521 follow:

1. Be a farmer, fruit grower or like association.
2. Be organized and operated on a cooperative basis either for:
   a. The purpose of marketing the products of members or other producers and returning to them the proceeds of sales less necessary marketing expenses on the basis of either the quantity or the value of the products furnished.
   b. The purpose of purchasing supplies and equipment for the use of its members or other people and selling them to them at cost, plus the necessary expenses. The value of supplies and equipment purchased for members must exceed the value of supplies and equipment purchased for nonmembers.
3. Organizations having capital stock must do the following:
   a. Limit the dividend rate on such stock to the greater of 8 percent per annum or the legal rate of interest in the state of incorporation on the value of the consideration for which the stock was issued.
   b. Substantially all of such stock, other than nonvoting preferred stock, must be owned by producers who market their products or purchase their supplies and equipment through the association.
4. Transactions with nonmembers must not exceed the value of transactions with members.
5. In the case of a purchasing cooperative, transactions with people who are neither members nor producers must not exceed 15 percent of the value of all transactions.
6. Section 521 cooperatives must allocate patronage earnings to members and nonmembers alike. This is unlike a non-521 cooperative that does not need to pay patronage refunds to nonmembers.

In Kansas, the number of qualified Section 521 cooperatives has declined over the last 40 years because many have decided that the costs of the qualification are more than the benefits they receive. One reason is that the government is no longer in the business of storing grain. When the government was paying elevators to store grain reserves, the potential existed for a cooperative to receive a considerable amount of nonmember income. The co-op could pay its patrons on a patronage basis and this would be eligible as a deduction from taxable income for qualified Section 521 cooperatives.

5.23 Legal Filing Formalities
Cooperatives are most often formed legally as corporations and must perform the same legal formalities involved with organizing any corporation. It is suggested that this publication be used as a general guide but an attorney be consulted when formally organizing a cooperative.

Articles of Incorporation
Kansas law requires that all cooperatives prepare and file a charter or articles of incorporation with the Secretary of State. A copy of the charter must also be on file with the Register of Deeds in the county of domicile. The charter must set forth the following:

1. The name of the association.
2. The purpose for forming the association.
3. A registered agent and address.
4. The term for which it is to exist.
5. The number of directors, which will not be less than five and may be any number in excess of five. The term of office for each director must also be stated.
6. If the cooperative is to be organized without capital stock, it must be stated whether the property rights and interest of each member shall be equal or unequal. If they shall be unequal, the application must set forth the general rules that will be applied to all members by which the property rights and interests of each member may and shall be determined and fixed. The association shall also have the power to admit new members who will be entitled to share in the property of the association along with the old members, in accordance with the general rules set forth by the charter. This provision requires consent of three-fourths of the members before it can be altered, amended or repealed.
Cooperative Bylaws

All cooperatives must adopt a code of bylaws to govern the management of the cooperative. The law states that the association must adopt its bylaws within 30 days after its incorporation. The bylaws may contain any or all of the following:

1. The time, place and manner of calling and conducting its meetings. If the association is to have an office or offices outside the state or if it may hold stockholders' and directors' meetings outside of the state, these too may be included.
2. The number of stockholders or members constituting a quorum.
3. The right of members or stockholders to vote by proxy or by mail or by both, and the conditions, manner, form and effect of such votes.
4. The number of directors constituting a quorum.
5. The qualifications, compensation, duties and term of office of directors and officers, time of their election, and the mode and manner of giving notice of an election.
6. Any penalties for violations of the bylaws.
7. The amount of entrance, organization and membership fees, if any, along with the manner and method of collection of the fees. The bylaws should also include the purposes for which the fees may be used.
8. The amount that each member or stockholder shall be required to pay annually or from time to time, if at all, to carry on the business of the association.
9. The charge, if any, to be paid by each member or stockholder for services rendered by the association to him and the time of payment and the manner of collection.
10. If there is to be a marketing contract between the association and its members or stockholders that every member or stockholder may be required to sign.
11. Any provisions on the number of members and qualifications of membership, including guidelines for the withdrawal of members or exchange of their stock.
12. The amount of annual dividends that may be paid on the common or preferred stock, that in no case shall exceed eight percent, and the manner in which the remainder of the association’s profits will be prorated in the form of patronage refunds to its several stockholders or members upon their purchases from, or sales to, the association or upon both such purchases and sales. The association’s bylaws may set forth any desired regulations that are not inconsistent to the powers granted by law.

Although the board of directors has the right to call special meetings at any time, the bylaws must set one or more meetings annually. The bylaws may also contain special provisions for qualifications of board members and how elections will be held, as long as these provisions fall within the law. The cooperative marketing law states that any provision of other laws that are in conflict with the cooperative marketing act will not be construed as applying to the associations organized under this act.

Since bylaws are set forth to govern operations of the association, it is important to make sure that the management and directors, even the members, are familiar with them. It is advised that the association’s bylaws are reviewed occasionally to make sure that they are serving the association’s ever changing needs.

Annual Report

Just like other corporations, cooperatives are required to file an annual report and pay annual franchise fees. The annual report must be filed with the Secretary of State and show the cooperative’s financial condition at the close of business on the last day of its tax period. If the cooperative's tax period is something other than a calendar year, it must give notice, in writing, of its different tax period to the Secretary of State prior to December 31 of the year it commences the different tax period. The annual report will be filed at the time of filing the cooperative’s annual Kansas income tax return. If the cooperative files for an extension on its income tax, it can also file for an extension on filing its annual report.

The Secretary of State has a prescribed form that a cooperative will use for its annual report. This form is much the same as for regular corporations. If you need further details on the requirements for the annual report, refer to the legal filing section of Chapter 3 on C Corporations.

At the time of filing the annual report in the state of Kansas, the cooperative will have to pay the Secretary of State an annual privilege fee of $20, that is an advantage over the franchise taxes that are paid by most other corporations.
5.24 Financing
Cooperatives are financed by the members who use their services. New members are usually required to purchase one share of stock, but often for only a very small amount ranging from $25 to $100. The remainder of a member’s investment will be earned over time in the form of retained patronage refunds. In this traditional system, there is a very small initial investment for new members.

Financing new generation or limited membership cooperatives is different from traditional cooperatives. Members must purchase shares of stock that are tied directly to delivery rights to market specific commodities. In these cooperatives, the initial investments are usually significant amounts of money. See Differences Between New Generation Cooperatives and Traditional Cooperatives for more information.

Unlike traditional cooperatives, stock in new generation cooperatives has a variable market rate dependent upon the performance of the cooperative. The stock in new generation cooperatives can be traded between members, usually subject to the approval of the board of directors.

5.25 Management
A distinguishing characteristic of a cooperative is that it is organized on the user-owned and user-controlled principles. The patrons or customers possess ultimate control over the decisions and directions of their cooperative.

Members of the cooperative elect a board of directors of not less than five directors to manage the affairs of the association. The directors then elect from their numbers the officers, such as a president or chairperson, one or more vice presidents (one of whom shall be a director), and a secretary and a treasurer (who need not be directors). The offices of secretary and treasurer may be combined into one office.

Directors may choose to elect a chairperson and vice chairperson in addition, or in lieu of president and vice president. The use of this terminology may be beneficial to those businesses that give the title of president to the chief executive officer or general manager, who need not be a farmer, a member or a director. However, the chairperson must be a director.

Typically the cooperative’s bylaws will set forth the process for electing board members. The bylaws will also provide guidelines for the appointment or election of any vacancies resulting for any other than expiration of term.

The members of a cooperative possess ultimate control over the actions of their association. Since it would be impractical for the entire membership to meet to approve all decisions, board members are elected to provide direction to the CEO. Since most cooperative board members are usually farmers, and are usually busy with their own work, management personnel are hired to conduct the day-to-day business of the cooperative.

The general manager takes the major responsibility of operational planning and a heavy involvement in strategic planning. Board members take a major role in strategic planning. The major responsibility of directing the operations of the cooperative falls within the responsibilities of the general manager, who also has total responsibility of organizing and staffing daily operations.

A distinct delegation of authority in the cooperative business structure is apparent. Although considerable authority is granted to the general manager, the board is ultimately accountable for the actions of the personnel and the performance of the company. So board members need to be educated on the legal guidelines placed on cooperative. Board members should become familiar with the articles of incorporation and bylaws to assure that the board is acting in the best interest of the membership and in accordance to the articles of incorporation and bylaws.

Board members may be held accountable for the consequences of their actions, which is true for board members of all corporations. However, directors of any corporation may be entitled to indemnification from the corporation. Additionally, the liability exposure of directors to members and stockholders may be limited by a provision in the articles of incorporation. Board members are obligated to abide by the provisions of the cooperative’s articles of incorporation and bylaws along with any statutes or contracts entered into by the cooperative.

5.26 Life of the Business
A cooperative is a corporation and is therefore viewed legally as an entity in itself, separate from its members. The life of a cooperative is continual. The death or insolvency of a member does not end the life of the business. Historically, cooperative law in Kansas limited the life of the business to 50 years. However, this law was changed to allow continual business life.

REFERENCES


House Bill 2298 (1995)
House Sub. for S.B. 336
IRC Sec. 164 (1995)
IRC Sec. 706 (1995)
IRS Revenue Procedure 95-10.
IRS Sec. 1402 (1995)

K.S.A. 16-207
K.S.A. 17-1501 et. seq.
K.S.A. 17-1601 et seq.
K.S.A. 17-1607
K.S.A. 17-1609 (1994 Supp.)
K.S.A. 17-1612 (1994 Supp.)
K.S.A. 17-1618
K.S.A. 17-6001 et seq.
K.S.A. 17-6305
K.S.A. 17-6612 (1994 Supp.)
K.S.A. 17-7503 and 7504
K.S.A. 17.7601 - 17.7651
K.S.A. 56-345 (1994 Supp.)


Rev. Proc. 95-10
Rev. Rul. 94-30


Senate Bill 108 (1993)
Senate Bill 336 (1995)


26 U.S.C. § 521
26 U.S.C. § 706 (b), Reg. 1.706
26 U.S.C. § 1382
26 U.S.C. § 1385
