

# TEN LIMITATIONS TO PONDER ON FARM LIMITED LIABILITY COMPANIES

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## I. INTRODUCTION

Choice of entity for family farm operations presents many unique issues to the attorney and has done so for many years. Family farms usually hold land as the primary appreciable asset. In addition, issues of passing the family farm to heirs,

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while retaining the economic viability of the farm, constantly vex the business and estate planning attorney.

Since the Internal Revenue Service (IRS) decided in 1988 that it would classify a Wyoming limited liability company as a partnership for federal income tax purposes,<sup>1</sup> all fifty states and the District of Columbia have passed statutes allowing the creation of limited liability companies (LLCs).<sup>2</sup> The LLC promises the tax benefits of a partnership and the limited liability of a corporation.<sup>3</sup> Many farm business and estate planners have reacted almost reflexively by placing family farm businesses into LLCs, without careful consideration of the consequences or the alternatives.

Although farmland generally should not be held in a subchapter C corporation for tax reasons, limited liability companies may not be the automatic choice. This caveat holds true especially if the attorney uses "boiler plate" language for the limited liability company organizational documents and operating agreement. This Article outlines the ten biggest issues raised by operation of the family farm in a limited liability company. The authors also suggest procedures to minimize the problems that may arise in these situations. However, this Article does not intend to comprehensively examine all aspects of limited liability companies or the choice of entity. The questions posed here merely form food for thought for the conscientious practitioner.

## II. IS "LIMITED LIABILITY" REALLY "LIMITED LIABILITY"?

One of the attractive features of limited liability companies (LLCs) is the so-called "limited liability." Namely, owners of LLCs (called "members"), like corporation shareholders, are liable for LLC debts only to the extent of their investment in the LLC.<sup>4</sup> The Uniform Limited Liability Company Act provides that a "member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager."<sup>5</sup> "State statutes typically shield members and managers from liability, except for willful misconduct or knowing criminal violations."<sup>6</sup>

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1. See Rev. Rul. 88-76, 1988-2 C.B. 360.

2. See 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1.06 (Supp. Dec. 1998) (reviewing the enactment of limited liability company statutes of respective states).

3. See 1 *id.* § 1.03.

4. See UNIF. LTD. LIAB. CO. ACT § 303(a), 6A U.L.A. 425, 454 (1995).

5. *Id.*, 6A U.L.A. at 454.

6. Carol J. Miller et al., *Limited Liability Companies Before and After the January 1997 IRS "Check-the-Box" Regulations: Choice of Entity and Taxation Considerations*, 25 N. KY. L. REV. 585, 593 (1998). See, e.g., VA. CODE ANN. § 13.1-1009(16) (Michie 1993).

Members of LLCs may lose the entire consideration they provided for their ownership interest in the entity, but no personal assets are at risk.<sup>7</sup> Compared to partnerships, this feature may offer great benefits to many owners compared to partnerships. However, this benefit offers little to the family farm LLC. First, the primary, if not only, major asset of a family farm LLC is land. The main asset that the family wishes to protect is the land. Since the land is in the LLC, the land is subject to LLC debt. If the family farm operation incurs significant liabilities, the land may be lost. The LLC structure provides no benefit in this respect over any other entity.

The hollow promise of limited liability is softened by two factors. First and foremost, every farm operation should carry liability insurance sufficient to protect the primary input—land—from attachment in liability suits.<sup>8</sup> With this protection, the land is insulated from a large class of risk, regardless of the entity.<sup>9</sup> Second, many other liabilities not covered by insurance cannot be protected by choice of entity.<sup>10</sup> Namely, lenders will likely require the land as collateral prior to giving any loan.<sup>11</sup> Lenders often require a personal guarantee of corporate and LLC loans.<sup>12</sup> Will not wise lenders require all owners to personally guarantee LLC debt? Therefore, the promise of limited liability means little in these circumstances, regardless of the amount of careful organizational planning.

LLCs do offer one liability advantage over partnerships. In partnerships, all general partners are personally liable for debts incurred by partners clothed with apparent authority by the operation.<sup>13</sup> Typically, general partners are subject to joint and several personal liability for torts or breach of trust committed within the scope of the partnership business by partners or agents.<sup>14</sup> The 1994 revisions to the Uniform Partnership Act expand this joint and several personal liability to all business debts.<sup>15</sup> Members of LLCs do not face this concern.<sup>16</sup> However, the land remains subject to obligations incurred by owners with apparent authority.<sup>17</sup> No amount of liability insurance coverage protects against this threat.<sup>18</sup>

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7. See Miller et al., *supra* note 6, at 593.

8. See *id.* at 594-95; NEIL E. HARL, FARM ESTATE & BUSINESS PLANNING 288 (13th ed. 1996).

9. See HARL, *supra* note 8, at 289.

10. See *id.*

11. See, e.g., Miller et al., *supra* note 6, at 587-595.

12. See HARL, *supra* note 8, at 288.

13. See UNIF. PARTNERSHIP ACT § 16(2) (1914) (amended 1994), 6 U.L.A. 125, 501 (1995).

14. See *id.* §§ 15-16, 6 U.L.A. at 456, 501.

15. See UNIF. PARTNERSHIP ACT § 306(a) (1994), 6 U.L.A. 1, 45 (1995).

16. See *id.* § 306, 6 U.L.A. at 45.

17. See *id.* § 307, 6 U.L.A. at 46.

18. See *id.*, 6 U.L.A. at 46.

Creditors may be able to “charge” the shares of an LLC if any distribution is made by the LLC.<sup>19</sup> Even if the LLC protects the assets of the LLC from non-consensual creditors, the income distribution would be open to loss to creditors.<sup>20</sup>

The limited liability protection offered by the LLC appears mainly as an illusion for the family farm operation. Liability insurance covers many risks and should be utilized by each family farmer. While “technical violation of record keeping requirements may not cause loss of limited liability status for LLC managers or members, other acts of wrongdoing and *environmental violations* may result in personal liability.”<sup>21</sup> Many farmers will incur personal as well as LLC liability when they drive and crash the LLC tractor or truck into Ned Neighbor.<sup>22</sup> Certain liability risks may not be prevented with insurance. With respect to these risks, the farm real estate remains subject to these debts regardless of the entity choice. Since family farmers wish to protect the real estate above all else, LLCs offer little or no benefit. Does your disclosure statement remind the client of the personal and farm liability for joint torts and likely requirement of co-signatures on loan documents?

### III. STANDARD LIMITED LIABILITY COMPANY OPERATING AGREEMENTS POSE PROBLEMS IN FAMILY FARM SITUATIONS

Most attorneys utilize “form” documents when organizing the family farm LLC. Although these forms may work well in a large percentage of situations, some provisions raise questions in the family farm situation. The main family farm asset, the land, is not easily divisible without threatening the viability of the farm.<sup>23</sup> An attorney or the family farm parents may view the LLC as a savior possessing the ability to divide the family farm assets without actual, physical division. This feat is often attempted through organization of the family farm as an LLC.<sup>24</sup> The parents then divide the family farm through gifting of ownership units, creating a group of minority owners.<sup>25</sup>

In some operating agreements, the purpose of the company is very broad. For example, the business of the company shall be:

- a. To accomplish any purpose or purposes for which persons lawfully may associate themselves or any other lawful purpose

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19. See *1st American Newsletter* (Sept. 1, 1998) <<http://www.falc.com/newslett/newsarch/news0998.htm>>.

20. See *id.*

21. Miller et al., *supra* note 6, at 595 (emphasis added).

22. See HARL, *supra* note 8, at 288.

23. See Steven C. Bahls, Planning to Minimize Conflict for Multiple Owner Businesses J-2-1, J-2-1 (1998) (unpublished presentation, 1998 American Agricultural Law Association Symposium, on file with *Drake Journal of Agricultural Law*).

24. See *id.* at J-2-3 to J-2-4.

25. See *id.* at J-2-16.

whatsoever or which shall at any time appear conducive to, or expedient for, the protection or benefit of the Company and its assets.

b. To exercise all other powers necessary to, or reasonably connected with, the Company's business which may be legally exercised by limited liability companies under the Ohio Revised Code.<sup>26</sup>

Such broad language, if non-farm or business heirs become minority owners by gift, purchase, or inheritance, invites litigation. Why should owners accept the historical three to five percent return to agricultural assets when a historical return of ten percent in the stock market or twenty percent development returns could be achieved for the "benefit of the company?" Does this language reasonably create an expectation by the non-farm heir holding an interest in the LLC that the managers of the LLC will manage the assets as an investment? This expectation implies that the managers must seek to maximize the return on investment. This obligation, perhaps a fiduciary obligation, may compel sale of the real estate and investment of the proceeds into higher yielding investments or development of the property for residential or commercial purposes.

As Dean Bahls has observed, "often those siblings who leave the farm receive no return with respect to their stock or partnership interest"<sup>27</sup> and "[c]hildren who work the family farm often feel betrayed by their siblings who elect [or are forced] to leave the farm."<sup>28</sup> This dissension and conflict of interest can be a major source of litigation and friction.<sup>29</sup> Although Dean Bahls goes on to state that family farm dissension comes from families relying on trust and goodwill instead of lawyers' well-crafted agreements governing family farm operations,<sup>30</sup> we see form book language such as that above as neither well-crafted nor helpful in reducing family dissension.

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26. Richard T. Ricketts & Matthew A. LaBuhn, *Drafting a Limited Liability Company Operating Agreement*, P-1-1, P-1-5 (1998) (unpublished presentation, 1998 American Agricultural Law Association Symposium, on file with *Drake Journal of Agricultural Law*). Similar provisions are in many operating agreements. See MARK A. SARGENT & WALTER D. SCHWIDETSKY, *LIMITED LIABILITY COMPANY HANDBOOK ST-1 to WI-117* (West 1997). Examples include permitted businesses of the company that generally "accomplish any lawful business whatsoever, or which shall at any time appear conducive to or expedient for the protection or benefit of the Company and its assets" and "engage in any lawful business activity." See *id.* at IA-11, IL-8.

27. Bahls, *supra* note 23, at J-2-1.

28. *Id.*

29. See *id.* The authors have been involved in farm family fights over control between minority interests who wanted a "big return" and were not satisfied with "agricultural returns." Assets are siphoned to lawyers and away from productive agricultural needs.

30. See *id.* at J-2-2.

Non-farm members should be provided with other than farm assets if available, such as insurance proceeds, non-farm stock, cash, heirlooms, forested land, parcels of land with long-term agreements, and less than equal distribution of assets should be considered or carefully drafted LLC documents be crafted to avoid dissension. For example, the following business purpose statement restricts the company to develop land:

The business of the company shall be to acquire the land and to develop, improve and construct or renovate improvements on the land and to lease, operate, manage, sell, exchange or otherwise dispose of the project, or any portions thereof, and to engage in any and all business activities related or incidental thereto.<sup>31</sup>

Similar language for the family farm might state:

The business of the Family Farm Company shall be to operate, manage, and acquire agricultural land and assets and to lease, operate, manage, sell, exchange, or otherwise dispose of the assets as appropriate for a 'family farm' operation and to engage in any and all business activities related or incidental thereto.<sup>32</sup>

A third possibility reads:

The business of the company shall be:

- (a) To operate a cow/calf operation with appurtenant grain farming operation.
- (b) To exercise all other powers necessary to, or reasonably connected with, the Company's business as described in paragraph (a) which may be legally exercised by limited liability companies under state law.<sup>33</sup>

This third possibility raises questions of what course of action is appropriate when economic circumstances force the family to consider changing the nature of the farm operation to, for example, begin a concentrated hog facility. The authors suggest that such a decision should *only* be made after a meeting and vote of the owners. At that time, the agreement may be amended if appropriate.

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31. See generally SARGENT & SCHWIDETSKY, *supra* note 26, at 3-37 (describing the development of LLC statutes).

32. See generally *id.*

33. See generally *id.*

Additional language could be added to suggest that the operation provides for family employment and efficient operation but also reflects farm family values, and is consistent with environmental stewardship, open spaces, and non-commercial development activities. In the business purpose or under dissolution, one could provide for the company to be dissolved only upon certain events happening. The on-farm heirs could trigger dissolution when they wish to leave the farm operation. In other words, if you do not keep the non-farm minority out, at least keep them at bay. This language could also be used to protect the nature and cost of the operation in case of divorce.<sup>34</sup> Are you using “boiler plate” language in your LLC agreements or do you address the family farm expectations of your clients?

**IV. ATTORNEYS DRAFTING DOCUMENTS FOR FAMILY FARM BUSINESSES SHOULD HAVE ALL PARTICIPANTS SIGN AN ACKNOWLEDGMENT AFTER DISCLOSING THE FACT THAT THE OPERATION WILL NOT BE A TRADITIONAL INVESTMENT AND WILL LIKELY NOT PRODUCE MARKET-LEVEL RETURNS**

In addition, all prospective members of the family farm LLC should sign an acknowledgment that recognizes that the return on the farm may be much less than traditional investments, but that the goal of the LLC is to keep the land in the family name and in farming. This acknowledgment could be contained within the operating agreement. A suggested form would be as follows:

The members acknowledge that the real estate comprising the primary asset of the Company is, and has been for many generations, a family farm. The goal and primary objective of the Company is to maximize the profit from the operation of the Company while retaining the primary asset's character as a family farm. An affirmative vote of interests representing at least sixty-six and two-thirds percent (66 2/3%) of all ownership units eligible to vote shall be required to convert the purpose of the Company to other than operating a family farm.

Does your file contain client statements reflecting an understanding of the investment and risk nature of production agriculture?

**V. DIFFERENCES IN FIDUCIARY OBLIGATIONS OWED BY OWNERS OR MANAGERS OF THE BUSINESS ENTITY MAY BE A SIGNIFICANT CONSIDERATION IN FORMING THE FAMILY FARM ENTITY**

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34. See discussion *infra* Part X.

The choice of entity may produce vastly different levels of fiduciary duty owed by an owner or manager of the entity. In a family farm situation, the fiduciary obligation owed makes a significant difference. The precise contours of the fiduciary obligation owed to members of a limited liability company remain unclear.<sup>35</sup> Similar doubt exists with respect to the duty owed to shareholders of a closely-held corporation.<sup>36</sup> Commentators generally acknowledge that the duty owed to partners is likely to be a higher standard of loyalty and care to one another than that imposed on a limited liability company or shareholders of a corporation.<sup>37</sup>

Both the 1994 Revised Uniform Partnership Act and the Uniform Limited Liability Company Act purport to limit partners' and managers' fiduciary duties.<sup>38</sup> Therefore, choice of entity becomes choice of fiduciary duty. Furthermore, if the parties choose to alter these duties of loyalty and care by agreement, this choice should be made only after full disclosure and discussion.<sup>39</sup>

Finally, fiduciary duty rules protect only owners of the business entity.<sup>40</sup> Should the attorney consider protection of other family members who may be "implicit owners" of the family farm, such as non-owner spouses?<sup>41</sup> What does your letter to the client say?

#### VI. THE NEW "CHECK-THE-BOX" RULES REDUCE THE IMPORTANCE OF MANY ENTITY CHARACTERISTICS

Since January 1, 1997, the IRS has treated domestic unincorporated business entities, including limited liability companies, as partnerships for federal income tax purposes.<sup>42</sup> Any business wishing to qualify as a different classification must file a Form 8832 election to change the tax classification.<sup>43</sup> In adopting the check-the-box regulations, the IRS acknowledged that the traditional arbitrary criteria used to distinguish partnerships from corporations mean little with the advent of hybrid entities such as limited liability companies and limited liability partnerships.<sup>44</sup>

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35. See Alysia C. Rollock, *Professional Responsibility and Organization of the Family Business: The Lawyer as Intermediary*, 73 IND. L.J. 567, 569 (1998). See generally Claire M. Dickerson, *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 417 (1995) (referring to the lack of uniformity of laws throughout the country).

36. See Rollock, *supra* note 35, at 569.

37. See *id.*

38. See UNIF. PARTNERSHIP ACT § 404, 6 U.L.A. 58, 58-59 (1995); UNIF. LTD. LIAB. CO. ACT § 409, 6A U.L.A. 425, 464 (1995).

39. See Rollock, *supra* note 35, at 569.

40. See Terry O'Neill, *Reasonable Expectations in Families, Businesses, and Family Businesses: A Comment on Rollock*, 73 IND. L.J. 589, 595 (1998).

41. See Rollock, *supra* note 35, at 584-86.

42. See Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 1998).

43. See Rev. Proc. 97-5, 1997-3 I.R.B. 15. See also Instructions for Form 8832 (1996).

44. See Miller, *supra* note 6, at 600.



The advent of the check-the-box rules reduces the importance of the characteristics of pass-thru taxation, limited liability, continuity of existence, and transferability of ownership interests when selecting the form of the business entity.<sup>45</sup> However, the check-the-box rules do not control issues related to control, estate tax, estate planning, bankruptcy, or securities regulation.<sup>46</sup> Check-the-box rules do not resolve family conflict. Has your LLC document addressed the tax issues?

#### VII. PIERCING THE VEIL—ACTION AND WORDS MATTER

The “veil” of an LLC has been little tested by litigation, and we do not know when an LLC might be pierced and its members held liable for its obligations.<sup>47</sup> Three recent cases provide some insight into how courts will treat LLCs.<sup>48</sup> The law for piercing the corporate veil is well established, and the authors assume that courts will follow corporate case law.<sup>49</sup>

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45. See Rollock, *supra* note 35, at 569.

46. See Miller, *supra* note 6, at 602-03.

47. See SARGENT & SCHWIDETSKY, *supra* note 26, at 3-37.

48. See *Miles v. CEC Homes, Inc.*, 753 P.2d 1021, 1023-24 (Wyo. 1988) (holding that evidence of inadequate corporate minutes, commingling of funds, a single majority shareholder, and the use of the corporation to procure labor and services for a shareholder amount to a piercing of the corporate veil); *Kloefkorn-Ballard Constr., Inc. v. North Big Horn Hosp. Dist.*, 683 P.2d 656, 661-662 (Wyo. 1984) (stating that note which was in writing and required interest paid was an arm's-length transaction); *AMFAC Mechanical Supply Co. v. Federer*, 645 P.2d 73, 76-78 (Wyo. 1982) (holding that fraud is not a prerequisite when inadequate capitalization is present to pierce the corporate veil).

49. In *Arnold v. Browne*, the court identified the following factors that justify disregarding the corporate entity or piercing the corporate veil:

[C]ommingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses; the treatment by an individual of the assets of the corporation as his own; the failure to obtain authority to issue or subscribe to stock; the holding out by an individual that he is personally liable for the debts of the corporation; the failure to maintain minutes or adequate corporate records and the confusion of the records of the separate entities; the identical equitable ownership in the two entities; the identification of the equitable owners thereof with the domination and control of the two entities; identification of the directors and officers of the two entities in the responsible supervision and management; the failure to adequately capitalize a corporation; the absence of corporate assets, and undercapitalization; the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation; the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest or concealment of personal business activities; the disregard of legal formalities and the failure to maintain arm's length relationships among related entities; the use of the corporate entity to procure labor, services or merchandise for another person or entity; the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets

Although many states are silent on piercing the LLC veil,<sup>50</sup> Colorado, Hawaii, Maine, Minnesota, North Dakota, and Wisconsin LLC Acts provide that the case law regarding piercing the corporate veil applies to members of LLCs operating in these states.<sup>51</sup> California law provides that:

An LLC member is personally liable under a judgment of a court, under the same circumstances and to the same extent as a shareholder of a corporation may be personally liable, except that the failure to hold meetings of members or managers or the failure to observe formalities is not a factor tending to establish that the members have personal liability where the articles of organization or operating agreement do not expressly require such meetings.<sup>52</sup>

Washington holds members of an LLC “personally liable for any act, debt, obligation, or liability of the LLC to the extent that shareholders of a Washington business corporation would be liable in analogous circumstances.”<sup>53</sup> Montana case law indicates that failure of an LLC to observe the “usual company formalities or requirements relating to the exercise of its company powers or management of its business is not a ground for imposing personal liability on the members or manager of the LLC.”<sup>54</sup>

Whereas the states have varying requirements, if any at all, for record keeping of an LLC and usual reports,<sup>55</sup> failure to meet these requirements by an LLC would

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in one and the liabilities in another; the contracting with another with intent to avoid performance by use of a corporation as a subterfuge of illegal transactions; and the formation and use of a corporation to transfer to it the existing liability of another person or entity.

Arnold v. Browne, 103 Cal. Rptr. 775, 781-82 (Ct. App. 1972). *See also* Miles v. CEC Homes, Inc., 753 P.2d 1021, 1023-24 (Wyo. 1988); Kloefkorn-Ballard Constr. & Dev., Inc. v. North Big Horn Hosp. Dist., 683 P.2d 656, 661 (Wyo. 1984); AMFAC Mechanical Supply Co. v. Federer, 645 P.2d 73, 77-78 (Wyo. 1982).

50. *See generally* GUIDE TO LIMITED LIABILITY COMPANIES ¶¶ 1003-1053, at 110-235 (CCH, Inc. 4th ed. 1997) (outlining the statutes from the states that do not have an express provision regarding piercing the corporate or LLC veil). The following states’ acts have no express provision concerning piercing the corporate or LLC veil: Alabama, Alaska, Arizona, Arkansas, Connecticut, Delaware, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, and Wyoming. *See id.*

51. *See* COLO. REV. STAT. ANN. § 7-80-107 (West 1998); HAW. REV. STAT. § 428-1202 (Supp. 1997); ME. REV. STAT. ANN. tit. 31, § 645 (West 1996); MINN. STAT. ANN. § 322B.303 (West 1995); N.D. CENT. CODE § 10-32-29 (1995); WIS. STAT. ANN. § 183.0304 (West Supp. 1998).

52. CAL. CORP. CODE § 17101 (West Supp. 1998).

53. WASH. REV. CODE ANN. § 25.15.060 (West Supp. 1998).

54. MONT. CODE ANN. § 35-8-304 (1998).

55. *See* CCH, *supra* note 53, at 110-235.

in most cases be grounds for piercing the LLC veil based on corporate case law.<sup>56</sup> In addition, lack of minutes and records may weaken the argument that there is a separate entity.<sup>57</sup> In our experience, farm families have failed to maintain corporate minutes. By analogy, LLCs may likewise be vulnerable unless you provide this service. Should you send a letter to the client containing a disclaimer or recognition that the law of piercing the corporate veil is not settled with respect to LLCs?

Three recent cases address the LLC veil. In *Hollowell v. Orleans Regional Hospital*,<sup>58</sup> the court held that under Louisiana law, the “veil” of protection afforded an entity by its limited liability company form “may be ‘pierced’ if in fact [the entity] was operating as the ‘alter ego’ of [the entity’s] members or if [the entity’s] members were committing fraud or deceit on third parties through [the entity].”<sup>59</sup> The court stated:

No case has yet explicitly held that the ‘veil’ of protection from liability afforded by the limited liability company form of business in Louisiana may be ‘pierced’ in the same manner as the ‘veil’ of protection afforded Louisiana corporations. However, commentators throughout the nation appear to agree that the limited liability company ‘veil’ may be ‘pierced’ in the same manner as the corporate veil. More specifically, several commentators appear to assume that indeed a Louisiana limited liability company’s ‘veil’ may be pierced. As Professor Kalinka notes in her Louisiana Civil Law Treatise on Louisiana Limited Liability Companies and Partnerships, ‘[t]he same policy considerations in piercing the veil of a corporation apply to an LLC.’ However, Professor Kalinka cautions that the analyses between corporate veil piercing and limited liability company veil piercing may not completely overlap, noting that ‘[b]ecause the Louisiana LLC law requires fewer formalities such as annual elections of directors, keeping minutes, or holding meetings, failure to follow these formalities should not serve as grounds for piercing the veil of an LLC.’<sup>60</sup>

Similarly, the U.S. District Court in Utah held that Utah courts would look beyond the corporate veil to find shareholders individually liable.<sup>61</sup> “While there is

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56. See generally *Arnold v. Browne*, 103 Cal. Rptr. 775, 781-82 (Ct. App. 1972) (discussing factors courts will look to determine “piercing the veil”).

57. See *id.* See, e.g., *Miles v. CEC Homes, Inc.*, 753 P.2d 1021, 1023-24 (Wyo. 1988); *Kloefkorn-Ballard Constr. & Dev., Inc. v. North Big Horn Hosp. Dist.*, 683 P.2d 656, 661 (Wyo. 1984).

58. *Hollowell v. Orleans Reg’l Hosp.*, No. CIV.A.95-4029, 1998 WL 283298, at \*10 (E.D. La. May 29, 1998).

59. *Id.*

60. *Id.* at \*9 (alteration in original) (footnotes omitted) (citation omitted).

61. See *Ditty v. CheckRite, Inc.*, 973 F. Supp. 1320, 1336 (D. Utah 1997).

little case law discussing veil piercing theories outside the corporate context, most commentators assume the doctrine applies to limited liability companies.”<sup>62</sup>

In *Water, Waste & Land, Inc. v. Lanham*,<sup>63</sup> the court held that the statutory notice provision of the Colorado Limited Liability Act did not relieve agents of their common law duty to disclose the existence and identity of their principals.<sup>64</sup> The court concluded that once the limited liability company’s name is known to a third party, “constructive notice of company’s limited liability status has been given, as well as the fact that managers and members will not be liable simply due to their status as managers or members.”<sup>65</sup> Counselors must impart the importance of using the LLC in *all* written and financial transactions by Ma and Pa Farmers if they are to preserve the LLC nature of the company. Have you addressed disclosure to third parties of the new business entity?

### VIII. SELF-EMPLOYMENT TAX AND RENTING FARM LAND TO THE LLC

Proposed regulations under I.R.C. § 1.1402 attempt to determine when income is subject to self-employment taxes.<sup>66</sup> Distributive share of trade or business income to a limited partner in a limited partnership is generally not self-employment income.<sup>67</sup> The proposed regulation treats LLC members as limited partners and not subject to self-employment tax unless the individual:

1. Has personal liability for the debts of or claims against the [entity] by reason of being a [member of the entity]. [The fact that a member guarantees a debt should not be sufficient to meet this criterion. The liability should have to arise by reason of the member’s statutory liability, not liability the member voluntarily assumes in his individual capacity];

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62. *Id.* at 1335-36 (citing Karin Schwindt, Comment, *Limited Liability Companies: Issues in Member Liability*, 44 UCLA L. REV. 1541, 1550-65 (1997); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 7-26 (1997); Rachel Maizes, *Limited Liability Companies: A Critique*, 70 ST. JOHN’S L. REV. 575, 579-81, 607 (1996); Eric Fox, Note, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1144-45, 1155-77 (1994); Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 403 (1991); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 445 (1992); Curtis J. Braukmann, Comment, *Limited Liability Companies*, 39 U. KAN. L. REV. 967, 992 (1991); Joseph P. Fonfara & Corey R. McCool, Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership*, 23 LAND & WATER L. REV. 523, 525 n.12 (1988); Robert G. Lang, Note, *Utah’s Limited Liability Company Act: Viable Alternative or Trap for the Unwary*, 3 UTAH L. REV. 941, 966 (1993) (noting veil piercing doctrine likely to apply to Utah limited liability companies and attempting to pierce the LLC of an attorney)).

63. *Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997 (Colo. 1998).

64. *See id.* at 1003.

65. *Id.*

66. *See* Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702, 1704 (1997).

67. *See* I.R.C. § 1402(a)(13) (1994).

2. Has authority to contract on behalf of the [entity] under the statute or law pursuant to which the [entity] is organized; or,
3. Participates in the [entity's] trade or business for more than 500 hours during the taxable year.<sup>68</sup>

In response to earlier proposed tax regulations, some commentators have urged the IRS to allow a bifurcation of interest for self-employment taxes for all forms of business entities—partnerships, LLCs, LLPs, sole proprietorships, and corporations.<sup>69</sup> Specifically, commentators have argued that self-employment taxes should not apply to “the distributive share of any item of income or loss of a limited partner”<sup>70</sup> and by inference the same would be true for a similar LLC interest. However, IRS proposed regulations treat LLC members either as a limited partner for the entire interest, or not at all if the LLC member did not meet the management test or limited partner equivalence test.<sup>71</sup>

One of the major frustrations of farmers has been the self-employment tax impact of renting farmland to a farmer-controlled entity.<sup>72</sup> In *Mizzell v. Commissioner*,<sup>73</sup> the court held that rent paid to a partner for land rented to the partner's partnership used for farming is subject to self-employment tax.<sup>74</sup> The IRS has ruled that cash rent paid from a corporation to shareholders is subject to self-employment because the shareholders were employees of the corporation.<sup>75</sup> The proposed regulation has been interpreted to allow a member of an LLC to hold different classes of interest—one that permits participation in management and one that does not.<sup>76</sup> The proposed regulations imply that the non-managerial interest would be exempt from self-employment tax.<sup>77</sup> Thus, amounts that are

68. Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. at 1703.

69. *See id.*, 62 Fed. Reg. at 1702, 1703.

70. *Id.*, 62 Fed. Reg. at 1702.

71. *See id.*, 62 Fed. Reg. at 1702.

72. I.R.C. § 1402(a)(1) excludes rentals received from real estate and from personal property leased with real estate from the self-employment tax, with two exceptions:

1. Rentals received in the course of a trade or business as a real estate dealer, *and*
2. Income derived by the owner of land if:
  - a. the land is used under an arrangement that provides:
    1. that another individual will produce agricultural or horticultural commodities on the land, and
    2. the owner of the land will materially participate in the production of the agricultural or horticultural commodities, and
  - b. there is material participation by the owner of the land with respect to the agricultural or horticultural commodity.

*See* I.R.C. § 1402(a)(1) (1994) (emphasis added).

73. *Mizzell v. Commissioner*, 70 T.C.M. (CCH) 1469 (1995).

74. *See id.* at 1470.

75. *See* Tech. Adv. Mem. 96-37-004 (May 1, 1996).

76. *See* Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. at 1703.

77. *See id.*, 62 Fed. Reg. at 1703.

demonstratively return on capital would not be subject to self-employment income tax.<sup>78</sup> Currently, the only way to avoid self-employment tax for farmers on the return of equity is to hold the land in a sub “S” corporation.<sup>79</sup> However, the sub “S” corporation has its limitations<sup>80</sup> and other legislative actions<sup>81</sup> might reduce the *Mizzell* problem. If the proposed tax regulations were adopted,<sup>82</sup> an important tax planning tool for farmers would be the LLC.

It appears that members of an LLC will be treated as limited partners for purposes of the passive loss rules.<sup>83</sup> Some commentators have argued that the “active” LLC members and general partners should be treated in the same way for purposes of passive loss rules.<sup>84</sup> How will you keep your client posted on tax changes impacting upon the viability of the LLC?

#### IX. TAX MATTERS—WITHHOLDING, FUTA, FICA, AND THE EMPLOYMENT OF FAMILY MEMBERS AND OTHER TAX ISSUES

Wages paid to children of a sole proprietor under the age of eighteen are not subject to Social Security and Medicare tax.<sup>85</sup> Federal Unemployment Taxes (FUTA) are not required on wages paid to children under the age of twenty-one<sup>86</sup> nor to a spouse employed by the other spouse in a trade or business.<sup>87</sup> Likewise, by implication, wages paid to a child who is a child of *all* members of an LLC are not subject to Social Security, withholding, Medicare (under age 18), and FUTA (under age 21).<sup>88</sup> However, an LLC with *one* non-parent member would subject all wages paid to children of principal LLC owners to Social Security, Medicare, FUTA and withholding regardless of the child’s age.<sup>89</sup> The same is true of a spousal employee of the LLC.<sup>90</sup> Many people form LLCs for estate and gift tax purposes,<sup>91</sup> including a

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78. See *id.*, 62 Fed. Reg. at 1703. Remember, the regulations are proposed and may change before being finalized.

79. See C. ALLEN BOCK & PHILIP E. HARRIS, 1998 FARM INCOME TAX SCHOOL WORKBOOK 319 (1998).

80. See *id.*

81. See *id.* at 318.

82. See Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. at 1702.

83. See Temp. Treas. Reg. § 1.469-5T(e)(3) (as amended in 1996); Priv. Ltr. Rul. 94-52-024 (Dec. 30, 1994).

84. See SARGENT & SCHWIDETZKY, *supra* note 26, at 3-40.

85. See BOCK & HARRIS, *supra* note 87, at 362.

86. See *id.* at 361.

87. See *id.*

88. See *id.*

89. See *id.*

90. See *id.*

91. See Joseph M. Mona, *Advantages of Using a Limited Liability Company in an Estate Plan*, 25 EST. PLAN. 167, 167 (1998).

desire to achieve a valuation discount.<sup>92</sup> Thus, when a percent of the LLC is transferred to someone other than Ma and Pa, the LLC is liable to pay self-employment tax, FUTA, and withholding on all family members who work for the LLC.<sup>93</sup> The valuation of minority interest itself creates some risk,<sup>94</sup> and family gifting of minority interests must be carefully carried out.<sup>95</sup>

Past experience has shown that when family farmers incorporate and become employees of the corporation, they may trigger the need for worker's compensation coverage. The same would be true for family farm LLCs, based on change of status. Should your engagement letter include a disclaimer or explanation of these issues?

#### X. DIVORCE PLANNING AND THE FAMILY LLC

Planning for divorce may seem pointless to many "family farmers," but ignoring the possibility of a breakup of the marriage by the spouse (or spouse of a partner owner or spouses of children owners) is negligence as it can wreck havoc on the business.<sup>96</sup> Careful planning should provide for financial settlements that are not disruptive of the "family farm company."<sup>97</sup>

Frazer advises that a pre-nuptial for a spouse not involved in the business should include provisions whereby the uninvolved spouse would receive a financial settlement rather than stock in the "family company."<sup>98</sup> Building other assets in the non-farm spouse can be useful in the event of divorce. Keeping company assets and liabilities separate from family assets is advised.<sup>99</sup> Buy-sell agreements may be especially important for those who did not sign a pre-nuptial. Provisions may include the following:

1. Limitations on ownership to those actively involved in the business.<sup>100</sup>
2. Forced sale by the departing spouse of the ownership interest to the remaining family members.<sup>101</sup>

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92. *See id.*

93. *See id.* at 167-68. This statement would be true for the Brother-Sister LLC, the Grandma-Dad LLC who employ Dad's spouse or child, and *all* other LLCs.

94. *See* Mona, *supra* note 91, at 168. *See also* *1st American Newsletter*, *supra* note 19.

95. *See* Burgess J.W. Raby & William L. Raby, *Gift to Entity or Gifts to Its Owners?*, 81 TAX NOTES 995, 997 (1998).

96. *See* Jill Andresky Frazer, *Divorce-Proofing Your Company*, INC., Sept. 1998, at 92, 94.

97. *See id.* The authors would argue that people who do good estate planning may also be doing good divorce planning. Families who talk about money seem to have fewer problems. Pre-nuptials may be appropriate. Keeping family assets out of joint property ownership should also be considered.

98. *See id.*

99. *See id.* This practice often proves difficult for undercapitalized farmers who live on the farm.

100. *See id.*

3. Prohibition on sale of ownership interest without the permission of the other owners.<sup>102</sup>
4. Identical treatment of separation and divorce for purposes of buy-sell agreements.<sup>103</sup>
5. Predetermined valuation methods for ownership interests.<sup>104</sup>
6. A Push-Pull clause. In a push-pull arrangement, a flip of the coin determines which partner sets the ownership interest value. The other owner gets the choice of whether to *buy* or *sell* at that price.<sup>105</sup>
7. Predetermined pay-out periods compatible with the family business.<sup>106</sup>
8. In the farm context, limitation of the operating company to, e.g., milking the cows and growing grain on land rented (long-term) by spouses, family members, off-farm heirs, and others to the operating entity. Then the operating company can have little of the real value of the family enterprise.
9. Prohibition of transfer of the LLC interest to an ex-spouse who was not an original owner.<sup>107</sup>
10. Use of an estate planning trust to avoid problems with children's ex-spouses.<sup>108</sup>

Is it negligent not to discuss divorce and its impact on the family farm operation when developing the business organization scheme?

#### XI. WILL CLIENTS PAY AND STAY?

The careful tailoring of each business operating agreement to the particular situation, as the authors advocate here, entails significant time and follow-up by the attorney. Many practitioners will rightfully question whether clients will pay for this service. If the clients do retain you to form the entity properly, will they return periodically to have necessary "tune-up" work done?

Practitioners are familiar with bargain basement shoppers who will go to the lowest bidder for services. The authors suggest that practitioners should wish these shoppers a fond farewell. The authors' experiences indicate that these potential

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101. *See id.* at 94-95.

102. *See id.* at 100.

103. *See id.* at 95.

104. *See id.*

105. *See id.*

106. *See id.* at 94.

107. *See id.* at 100.

108. *See id.*



clients will present more headaches and potential liability for the practitioner than the fees will generate merit.

More importantly, practitioners owe a duty of adequate representation to all clients. Failure to consider the points raised by the authors may constitute negligence by the practitioner. Does the practitioner prefer to earn a quick, easy fee or practice law ethically and responsibly?

## XII. CONCLUSION

The authors are not opposed to LLCs for farm family-held businesses. With current and proposed income, estate, and gift tax laws and opportunities, the LLC is likely to replace the family limited partnership, sub-chapter S, sub-chapter C corporations, and the general partnership for many aggressive farm family operations. The authors believe careful drafting, crafting, and planning are necessary to provide the farm family with a viable business entity and not just a tax and litigation albatross waiting to happen.

Multiple entities will still be appropriate in many family farm situations with multiple family land owners renting land to the operating LLC. Some of the land may itself be owned by the LLCs. In our ten points to ponder, we urge the practitioner to raise issues unique to farm family clients. Have you explained to your clients the limits of limited liability companies?