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How A Worker Co-op Structured as a LLC Can Retain Earnings

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Meet Cathy, the Cooperative Development Institute's new answerwoman! She can take on any co-op questions you might have, big or small. Today we address the submitted question: "How can a worker co-op structured as an LLC retain earnings?" See all of Cathy's answers and ask your own on her home page.

This post was written with input from David Hammer (ICA Group), Joe Rinehart and Camille Kerr (Democracy at Work Institute), and Andrew Danforth (Cooperative Development Institute).

What's a LLC?

First, some background. The concept of a limited liability company was invented in 1977 in Wisconsin, relatively recently, and developed through the 1980s. State statutes that allow formation of an LLC now exist in every state, following the publication of a "model" statute in 1996. An LLC is not a

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corporation, meaning that although it is a legal entity it does not have the status of a "person". It does however confer (as the name implies) limited liability to its owners for the entity's debts.

A single person can form an LLC, which differs from a sole proprietorship in that there are a few more requirements to set it up, sometimes including yearly fees, and it confers limited liability for debts.

Several people can form an LLC, which is for the most part treated as a partnership, except that the members have limited liability.

Like a partnership or a sole proprietorship, an LLC by default has pass-through taxation, meaning the LLCs income goes to the member(s) and is taxed at their individual tax rates. The LLC can also elect to be taxed as a corporation, through the filing of IRS Form 8832, meaning that income could be taxed twice (once at the LLC level, at the corporate income tax rate, and once at the individual member level, as dividend income). An LLC electing to be taxed as a corporation, but an S corp rather than a C corp, pays taxes only at the individual level. (See here.)

(The tax situation can get dizzyingly complex. For more on how taxes can impact co-op members based on LLC vs. corporation structure, see Part 2: How does a co-op structured as an LLC affect members' individual taxes?)

Why would a co-op want to form as an LLC?

We'll come back to how taxation works in a moment. But first, why would a co-op want to form as an LLC? It may be that an existing business structured as an LLC is changing into a co-op, so modifying the existing LLC is the preferred route. Also, a worker co-op structured as an LLC that pays "owners' draws on profit" rather than wages can avoid violating employment laws. For co-ops with workers who do not have a legal right to be employed in the U.S., this option can be an attractive one. However, it must be structured as a member-managed (as opposed to manager-managed) LLC, which precludes having a separate board and

--None--

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requires that all members participate in the decision-making of the cooperative.

However, co-op developers largely frown on avoiding the employer-employee relationship for any other reason. David Hammer of the ICA Group says, "While some might say that the LLC model is the best because it allows co-ops to ditch the employer / employee relationship, I think that's an extremely dangerous and impractical decision. Workplace injuries are a real issue and going without workers' comp puts the members at risk. And as an owner, if you want to pay for workers' comp, the rates are really high."

For an overview of other considerations regarding choice of entity, such as flexibility, openness to outside investment, scale, name, administrative burden, etc., see the Democracy at Work Institute's choice of entity chart.

Can a LLC retain earnings?

Now here's a problem: as far as the IRS is concerned, an LLC is (usually) merely a vessel through which revenues flow on to members. Money is not meant to stick around, unallocated, in the business. There are a few reasons that businesses might like to retain earnings:

- money you've earned is the cheapest, friendliest source of investment capital;
- lenders like to see equity on the balance sheet of the company;
- it hurts less (psychologically) to allocate losses to a collective account than to individuals' accounts;
- keeping some indivisible reserves reduces the temptation to members to sell out the company;
- retaining earnings positions the cooperative as a vehicle to retain wealth locally and to grow in the future, indicating that the co-op is aiming not just for the current benefit to members but for future benefits to potential future members and the community.

So, *can* an LLC retain earnings? If so, how?

LLC taxed as a corporation

When a co-op meets the IRS definition under Subchapter T of the IRS Code (a very basic threshold: the company is owned and governed by members who patronize the enterprise, and surplus is distributed according to members' patronage), the co-op's business income is only taxed once, at the corporate (or in this case LLC) level ***or*** at the individual member level. This is similar to the treatment of an S Corporation, tax-wise, but is not subject to the same rules and requirements.

If you elect to tax an LLC as a corporation (as opposed to a partnership), **you *can* retain earnings**. (See here for example.) And presumably your co-op would meet the requirements to be taxed as a T corp, saving some money. At that point though the LLC must be treating worker-owners as employees, so you've lost the ability to have worker-owners who can't legally be employees, to not pay workers' comp, or to do payroll only in owners' draw.

Additionally, LLCs are capped at retaining $250,000 before they start having to pay close to 40% tax on any excess. (See here for example.) The amounts in written notices of allocation to members are *not* included in retained earnings (see here and here). Of course, the LLC can elect to be taxed as a C-Corp, but if you're going to be taxed as a C-corp, why not just incorporate as a C-corp?

LLCs taxed as a corporation may be attractive for smaller businesses because of the less rigorous administrative requirements (board minutes, annual meetings, etc.). Camille Kerr says, "I believe that an additional benefit of an LLC taxed as a corporation is that the ownership structure is completely flexible. With an LLC, you can separate profit rights from decision making rights, etc., unlike in a C-corp where the default structure is one share one vote."

For an in-depth article looking at the various considerations of LLC vs. corporate form and taxation, go here.

LLC taxed as a partnership: "permanent capital member"

OK, that's the "taxed as a corporation" story. But usually, an LLC is taxed as a partnership, in which case all the surplus needs to flow into the LLC members' accounts. However, if you do still want to retain earnings, you can have one of the members be a separate, subsidiary LLC (whose sole member is the parent LLC) whose express purpose is to retain earnings. The subsidiary LLC would pay taxes on that income, but retain it. (The "permanent capital member" subsidiary LLC would be taxed as a corporation, at a combined Federal and state rate of perhaps 24%, plus a state entity fee–which for example is $500 in MA. This is fairly heavy if it is a small business, and if it is larger, it would hit much higher federal tiered rates.)

You'd also have to specify in the member agreement what percentage of the profits that LLC member would get – the remaining profits would be distributed based on labor patronage. In this case you would not elect to be taxed under Subchapter T, because the parent LLC doesn't have any tax obligation.

This is neither any easier, more efficient, nor cheaper than filing as a C-Corp with co-op by-laws, but it's a workaround. It requires some lawyering to make it work. Co-op developers' default recommendation is to stick with a traditional stock corporation. But the workaround has been used, especially for co-ops with workers who are not allowed to be employees in the U.S., and you can find templates for doing it that way if needed.

LLC taxed as a partnership: subordinated debt from members

A different workaround for retaining earnings when you have an LLC is to hold members' capital accounts internally, and have a long post-employment payout period in the operating agreement. Perhaps part of the payout includes a portion made as interest-bearing, subordinated loan over a long period of time. This would retain a portion of capital in the LLC for long periods of time without taxation to the co-op and with some long-term benefit to the member, who would otherwise lose this part of their accrued earnings allocated to the "permanent capital member".

When a member's equity is "swapped" for subordinated debt in this way, it is still considered a positive to many lenders and some count it (depending on term, control of disbursement, and internal underwriting policies), as equity. Note that the IRS assumes a minimum interest rate on debt (called the "minimum imputed interest rates", which it sets monthly – see here), regardless of your written agreements. They do not impose any prepayment penalty.

Having the LLC keep subordinated debt–i.e., friendly loans from members–satisfies some of the reasons for wanting retained earnings, such as having low-cost investment capital and satisfying other lenders' desire for equity (or at least "equity-like") capital. It doesn't solve the problem of needing to allocate any losses to individual members, nor does it guard against the temptation to dissolve the co-op and sell out. Furthermore, members are taxed on the allocated earnings in the year they are recorded, even though they do not receive the funds that year, which can be a financial hardship for some workers–especially if it means getting lifted over the threshold to receive benefits and assistance. These issues would need to be addressed in other ways. (More considerations on the impact on individuals of having an LLC versus a corporation structure are explored in Part 2: How does a co-op structured as an LLC affect members' individual taxes?)

Summary

Have we completely confused you yet? Navigating choice of entity is difficult. And changing entity type once you've gotten going is a pain. So investing in planning and research to figure out how your business will be capitalized, initially and ongoing, is a necessary task.

Here are some of the key questions to focus on:

- Do you expect you may have members who don't have the legal right to be employed in the U.S.? An LLC structure can help sidestep that issue.
- Are you starting off from an existing business organized as an LLC? Then re-writing the operating agreements to reflect a cooperative structure could be most expedient.
- Do you expect to be a not very capital-intensive business, without a big need for inventory, pre-payment of payroll, heavy marketing, equipment, or real estate? Then retaining

earnings may not be a big issue for you, and an LLC or S-corp structure might suit you.
- Alternatively, do you expect to need to raise large amounts of capital, both equity and debt? A C-corp can issue different classes of stock, with only "common" stock having voting rights, and "preferred" stock getting paid any dividends first, but not having voting rights. Some large co-ops use this form to raise equity, and some smaller co-ops have used "direct public offerings" to sell preferred shares to the public in one or two states where they do business.
    - *A note of caution:* co-ops can treat payment of interest on loans as an expense, which reduces their corporate income on which they might have to pay taxes. But dividends on preferred shares come out of corporate income, so corporate taxes are assessed on that income *before* it is used to pay dividends. To put it another way, a co-op doesn't have to pay taxes on the money it pays for interest on debts, but it does have to pay taxes on the money it pays for dividends to shareholders.
- Are there other considerations, such as being able to offer (and deduct) employee benefits, that would apply to you? Be aware of what is allowed for each type of entity.
- What taxes and deductions will apply to the co-op or to individuals, under what circumstances? E.g. payroll tax/self-employment tax, corporate income tax/individual income tax, business expenses, etc. (See Part 2: How does a co-op structured as an LLC affect members' individual taxes? for more details on this question!)

Do your research, and then go talk to a knowledgeable lawyer and accountant.

Tagged on: business cdi co-op cooperative LLC worker worker cooperatives

Co-op Cathy July 1, 2015

Business Ownership Solutions News, CDI News, Co-op Cathy

← Thank You Kathleen; Welcome David!

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