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Forming a Worker Coop: LLC or Cooperative Corporation?

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By Sara Stephens, Sustainable Economies Law Center (SELC) Housing and Cooperatives Attorney

We want to create a worker cooperative...what legal entity should we form?

This is probably the most common question I hear at our Resilient Communities Legal Cafes. Lots of entrepreneurs come to us wanting to form a worker-owned business, but they are unsure what legal structure will work best for them. Are they required to form as a cooperative corporation? What if they're not ready to incorporate yet? Can they form as an LLC or some other entity and still be a cooperative? What are the benefits and drawbacks of the entity options?



Worker cooperatives, at their core, are worker-owned and democratically governed businesses. Some states have cooperative corporation entities under which a worker cooperative can choose to form. And the federal government gives preferential tax status for cooperatives under Subchapter T. These state and federal laws codify many of the bedrock practices of worker cooperatives, such as giving each worker an equal vote and distributing profits on the basis of work (not capital investment).

However, a business could form as any type of for-profit legal entity and operate as a cooperative. (For ways a nonprofit can become more democratic, check out our resources on [Worker Self-Directed Nonprofits](#).) An LLC, for example, may not be able to rely on state law to preserve its cooperative practices, and it may not qualify for Subchapter T tax status. But it can still provide empowering jobs, a democratic workplace, and local wealth creation just like a worker cooperative corporation.

Below are some of the key considerations in the choice between the two most common entity types for coops: the cooperative corporation and the limited liability company (LLC). I will be discussing California law specifically, but many of these points apply under other state laws.

Employment status

Worker cooperative members often don't feel like they are employees, especially when the company is just starting up and everyone is pitching in equally as co-founders. So it can be perplexing to realize that in many cases worker-owners need to provide themselves with employee protections from day one— like minimum wage, workers compensation insurance, and paid sick leave. This can be daunting for a startup whose founders intended to volunteer their time at the beginning. Likewise, immigrant members may be required to complete I-9s showing they are authorized to work in the US. The coop (and its members) could suffer steep fines and penalties for not treating themselves as employees under employment law and immigration law.

But there are ways to avoid employee status for coop members, and a key starting point is the entity type. [As discussed in more detail here](#), workers for corporations are presumed to be employees in California for employment law purposes. However, managing members of LLCs are not, assuming everyone shares in the ownership and control of the business. Additionally, these members are exempt from the worker's compensation requirement, whereas workers for a corporation who are not on the board must be covered. For immigration law purposes, entity type is less important, but an LLC member who pays self-employment tax may be less likely to be classified as "employed" by the coop than a worker on payroll who receives a W-2 from a corporation.

Courts have not formally weighed in on many of these issues for cooperative corporations specifically. So it is a legal gray area. One recent addition to the CA cooperative corporation law potentially makes it less risky for

cooperative corporations to treat themselves as owners rather than employees: "Election to be organized as a worker cooperative or an employment cooperative does not create a presumption that workers are employees of the corporation for any purposes." (Cal. Corp. Code section 12253.5) It has yet to be seen how persuasive this might be to a court.

Crucially, no matter what entity type a coop chooses, if its workers do not have significant ownership and control over the management of the business, they will likely be considered employees. But for coops that distribute governance among their workers, entity type may be a deciding factor as to the employment status of its members.

Offering investments

Worker coop corporations in California have a significant advantage over LLCs for receiving investments from community members. A recent bill (AB 816) amended the cooperative corporation statute and created a new "community investor" member category. Community investors can invest up to \$1,000 each without triggering cumbersome securities registration requirements. Additionally, the worker coop can limit the voting rights of investors to ensure that workers retain control over business decisions.

In an LLC, managing members are exempt from securities law requirements, but passive investor members generally are not.

Both entity types may be able to take advantage of a few other securities law exemptions, but there is nothing equivalent to the "community investor" opportunity for LLCs. Additionally, traditional investors are likely to be more familiar and comfortable with receiving shares from a corporation rather than ownership interests in an LLC. So for cooperatives that want to crowdfund investments from their community or seek other significant investment capital, the coop corporation is likely the more strategic route to go. You can [read more about community investors here](#).

Taxation

Generally, LLCs are pass-through taxation entities. This means that business revenue, as well as tax liability, are passed on to the members; the LLC itself is not taxed. LLC members receive K-1s and must pay self-employment tax on a quarterly basis for their share of the revenues— whether they receive that as wages (technically, draws on profits), year-end dividends, or even if it stays within the business. LLC members additionally pay personal income tax on the amount they receive (although they can deduct half of the self-employment tax payment).

In contrast, workers for a cooperative corporation are taxed in a more familiar and straightforward manner. They receive W-2s, file taxes annually, and the coop withholds employment taxes. They do not need to pay tax on retained earnings that are not allocated to their individual capital accounts. Workers pay employment tax only on their wages, and pay personal income tax on their wages and profit dividends. Additionally, cooperative corporations can take advantage of Subchapter T, which allows it to avoid entity-level tax on revenue generated by members.

Some worker coop members find it very cumbersome to pay quarterly self-employment tax, especially on retained earnings that are not paid out to the workers. These coops may prefer forming a corporation (or opt to be taxed as a corporation) in order to avoid that. Other coops form as LLCs and make the tax issue less of a problem by doing things like training their members about how to pay self-employment tax and by withholding part of members' pay, distributing it to the members when taxes are due.

My opinion: the cooperative corporation is usually the best choice

The above considerations are not exhaustive, and anyone thinking about starting a coop should seek individualized legal advice about what entity to form. Generally, I believe the cooperative corporation is the best entity for worker cooperatives unless the members are undocumented. While a startup may find it easier to begin as an LLC (or even a simple partnership), it is often strategic for it to convert to a cooperative corporation to take advantage of the many benefits of the entity type: legal protection of cooperative principles and practices, offering community investor shares, Subchapter T taxation, the use of the word “cooperative” in the business name, ease of retaining capital and expansion, more straightforward accounting, etc. However, when workers have barriers to employment, an LLC can provide a pathway to becoming co-owners of an empowering, democratic, and wealth-building enterprise.

More information on choice of entity can be found on [SELC’s cooperative e-resource library here!](#)

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