

# Options for Worker Co-op Legal Structure

California Co-op Conference  
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# Options for Worker Co-op Legal Structure

Cooperative (California or some other state)

Partnership

LLC

L3C

Corporation (S or C)

Tax Exempt Corporation

Additional option: B Corp status

# Issues to Consider

Liability Protection (inside and outside)

Siren protection

Need for outside investment

Tax treatment

Ease of operation/accounting

Settled law

Employee vs. Owner

Using the word “cooperative”

# Partnership

Automatically created when a group of people get together to run a business – no filing required

No liability protection for partners – each partner is personally liable for any liabilities or debts of the partnership

Not required to pay California \$800 minimum franchise tax

Pass through entity for tax purposes

Partners are not employees

# Corporation

The classic business form – no siren protection!

Shareholder primacy (vs. stakeholder statutes)

Liability protection for owners (shareholders)

Owners that work in the company are employees

- No self employment tax

- Employment law applies

Standard form used when outside investors are needed

Dividends must be in proportion to stock ownership

Observing formalities/piercing the corporate veil

Note that a California co-op is a type of corporation

Biggest complaint about corporations: double tax

One solution: S election – taxed like a partnership

Another solution: special tax treatment for co-ops

# S Corporation

Just like a corporation but with special tax treatment

Special requirements to maintain S Corp status:

- No more than 100 shareholders

- Shareholders must be individuals; citizens or legal residents

- Only one class of stock (different voting rights not considered a different class)

Failure to meet these requirements results in automatic loss of S status

California: 1.5% tax on entity (\$800 minimum)

Owners are employees – no self employment tax

A little bit more about pass through tax treatment – allocations versus distributions and the phantom income problem

# LLCs and L3Cs

LLCs have the limited liability of a corporation and are taxed like partnerships (they can elect to be taxed as corporations)

Owners (members) are not employees

Member managed vs. manager managed

All earnings subject to self employment tax (guaranteed payments and profits)

Phantom income problem

Gross receipts tax in California

Cannot have unallocated equity – all equity is allocated to member capital accounts (can create instability)

You can't use an LLC if you need a contractors license

Very flexible

No formalities required – harder to “pierce the veil”

Superior with respect to outside liability protection

L3Cs are LLCs specially designed to attract foundation investments – can only be formed in about five states

# L3Cs

Foundations are required to distribute five percent of the value of their net assets for charitable purposes each year. To meet this requirement, foundations primarily make grants to charitable organizations. However, foundations are also permitted under the Internal Revenue Code to invest this five percent of net assets in for-profit entities that meet a three-pronged test:

The entity must be formed primarily for charitable or educational purposes,

No significant purpose of the entity is the production of income or the appreciation of property,

No purpose of the entity is to conduct legislative or political activities.

(Internal Revenue Code (IRC § 4944(c) and Treas. Reg. § 53.4944-3)

The investment (called a Program-Related Investment or PRI) may produce significant income or capital appreciation so long as the production of income or the appreciation of property is not a significant purpose.

PRIs are relatively uncommon because foundations are unwilling to risk the uncertainty of having the IRS determine that a PRI it makes does not in fact meet the statutory requirements.

L3Cs were created in response to this problem. An L3C is identical to an LLC except that it is organized for a business purpose that satisfies and is at all times operated to satisfy each of the requirements for a PRI.

# Co-ops

Co-op statutes exist in all states – Mass. was first in 1866

Co-ops were created in response to monopolistic exploitation of farmers

Ironically, these monopolies tried to use antitrust laws to weaken co-ops

One court observed, “Naturally the co-operative movement among the farmers has aroused the opposition of the financial combinations, from whose unlimited power in fixing prices the farmers are seeking to free themselves”

Congress created exemptions from antitrust laws for ag. co-ops

Worker cooperatives are more recent and the law governing them is less clear

What is a co-op?

1. Owned and controlled by its “patrons” (customers, producers, workers . . . .)
2. One person one vote
3. “Surplus” is returned to the owners on the basis of their patronage

Note that these characteristics can be built into almost any legal structure (but beware the siren . . . .)

# Co-ops

Unlike the laws governing corporations and LLCs, cooperative statutes differ quite a bit from state to state

The California cooperative statute contains ambiguities and is designed for consumer co-ops

Massachusetts has a statute specifically designed for worker co-ops

Several states have created a new model based on the LLC instead of the corporation – Iowa, Wyoming, Wisconsin, Minnesota, & Tennessee – designed to facilitate outside investment – vary as to how much they protect patron primacy

A California business may form under another state statute but will be subject to California taxes and California law (CCL 2115); required to hire an agent in other state and qualify to do business in CA

In California, you may not use the word cooperative in your name unless you are formed under a cooperative statute

# Co-op Accounting and Tax

Tax advantages of co-ops under Subchapter T of the IRC

To qualify for taxation under Subchapter T:

- Benefits of operation to members

- Democratic control by members – one member one vote

- Earnings returned in proportion to patronage

What is the tax advantage for co-ops? Surplus attributable to member labor is not subject to the corporate double tax. Surplus allocated to members on the basis of their patronage is taxable to the members but not to the co-op.

Some co-ops generate revenue from both members and non-members. Example: Co-op A has ten members and two non-member employees (they are in their probation period and have not yet been admitted as members) – the co-op must determine how much of its surplus was generated from the work of the members versus the non-members. Only the portion generated from the members is exempt from the corporate double tax.

# Co-op Accounting and Tax

When members join a co-op, they make an initial capital contribution. This is the starting balance in the member's capital account. The capital account is not a separate bank account but is accounted for on the books of the co-op and is basically the property of the member, though the funds are kept in the co-op's account. The co-op has rules about how and when the members can get the contents of their capital account back out of the co-op. Usually, a member does not get his/her capital back until he/she leaves the co-op. Often when he/she leaves the co-op, the balance in the capital account converts to a loan from the departing member to the co-op and the co-op pays it back over time.

At the end of each year, the co-op determines whether its revenue exceeded expenses. If there was a surplus of revenue over expenses, the co-op may decide to retain a portion of the surplus in a "collective account" as a reserve. The collective account is separate from the member capital accounts (compare to LLCs where this cannot happen).

After setting aside a reserve in the collective account, if there is still additional surplus, the co-op will pay patronage dividends to its members. Patronage is usually calculated based on hours worked.

# Co-op Accounting and Tax

The co-op can choose to pay the entire patronage dividend in cash, or it may pay a portion in the form of an IOU (called a Written Notice of Allocation).

The use of WNAs allows the co-op to retain more cash within the co-op. However, these funds, unlike the surplus allocated to the collective account, are allocated to the member capital accounts and become the property of the members. The co-op sets policy as to when members may withdraw these funds as cash from their accounts. One common practice is to redeem WNAs on a three year rolling basis. Some co-ops pay interest on the balance in the member capital account.

The members pay income tax on the ENTIRE patronage dividend, regardless of whether it was received in cash or in the form of a WNA.

If members receive less than 20% of the patronage dividend in cash, the WNA is nonqualified and the co-op may not benefit from the Subchapter T exemption from double tax. The member does not pay tax on a nonqualified WNA until he/she receives it in cash.

Losses may also be allocated to member capital accounts as determined by the co-op.

# Uncertainty about Taxation of Patronage Dividends in Worker Co-ops

Over the past few years, IRS Examination (audit function) undertook correspondence “audits” of several members of worker cooperatives asserting the position that the member’s patronage dividends are subject to self-employment (SE) tax. Attorney Greg Wilson fought these cases asserting that patronage dividends were not subject to SE tax for various reasons. Eventually, an attorney for the IRS – IRS Counsel’s Office – in San Francisco, asked the IRS National Office for guidance on this issue. It appears that the IRS National Office concluded that patronage dividends paid by worker cooperatives are indeed not subject to SE tax and dropped the cases where it was asserting SE tax applied to worker coop patronage. But the IRS arrived at this conclusion because they determined the worker/members are employees of the cooperative and employees generally cannot receive both employment and self-employment compensation from the same entity. Continuing with this theme, the IRS then hinted that its position might be that patronage dividends paid by worker coops should be subject to employment taxes at the cooperative level – instead of SE tax – like a bonus paid to an employee. Where the IRS is going with this now is unclear.

# New Generation Co-ops

## Example:

Wisconsin's Chapter 193 authorizes the creation of membership interests for investors who are not patrons of the cooperative. Such investor-members' voting rights may not exceed a total of 49 percent but the bylaws may provide such members with the power to veto certain unusual decisions such as merger or dissolution. And the investors' may not receive more than 70 percent of the profit allocations and distributions of the cooperative. A cooperative formed under Chapter 193 may elect to be taxed as a partnership under Subchapter K of the Internal Revenue Code, or as a cooperative under Subchapter T.

# Co-op Governance

Articles of Incorporation

Bylaws

Members/Owners/Employees/Patrons

Board elected by members (minimum of 3 – need not be members)

Officers

Can a California co-op have outside investors? Preferred shares with no voting rights

# Nonprofits

501(c)(3) nonprofit public benefit corporation

501(c)(6) nonprofit mutual benefit corporation

501(c)(12) benevolent life insurance

associations of a purely local character,  
mutual ditch or irrigation companies, mutual  
or cooperative telephone companies, electric  
companies, or like organizations

# B Corps

Clients often ask us about how to become a B Corp. There is some confusion as to what it actually means to be a B Corp. First, it is important to understand that it is not a statutory business form. In fact, any business form can be a B Corp – this is slightly confusing because the name implies you have to be a corporation. In fact a sole proprietorship, partnership, LLC, LLP, co-operative, or any other type of business can be a B Corp.

One of the fundamental characteristics of a B Corp is its commitment to take into account the interests of the community, workers, the environment, and other stakeholders when making decisions. Ideally, this commitment should be reflected in the formation documents of the company. However, believe it or not, in many states, making such a commitment can expose a corporation's board to potential liability.

In approximately 30 states, there exists what is known as a constituency statute. These statutes vary but in essence they allow the board of a corporation to consider the interests of constituents other than the shareholders when making decisions. A corporation in a state without a constituency statute must do what is in the best interests of the shareholders (investors) – period. The board has a great deal of latitude (in most cases) to determine what is actually in the best interest of the shareholders, but the board cannot legally put the interests of the community, the environment, workers, or any other stakeholder group ahead of shareholders' interests. For example, the California Corporations Code provides that "A director shall perform [his/her] duties . . . in a manner such director believes to be in the best interests of the corporation and its shareholders . . ." Thus if the board of a California corporation made a decision to protect the environment, for example, at the expense of what was best for the company and its shareholders, the board members could be liable to the shareholders.

If a corporation is incorporated in a state with a constituency statute, the company must add language to its articles of incorporation to become a B Corp requiring the board of directors to consider "such factors as the Director deems relevant, including, but not limited to, the long-term prospects and interests of the Company and its shareholders, and the social, economic, legal, or other effects of any action on the current and retired employees, the suppliers and customers of the Company or its subsidiaries, and the communities and society in which the Company or its subsidiaries operate, (collectively, with the shareholders, the **"Stakeholders"**), together with the short-term, as well as long-term, interests of its shareholders and the effect of the Company's operations (and its subsidiaries' operations) on the environment and the economy of the state, the region and the nation."

A corporation incorporated in a state without a constituency statute could face liability if it put this language into its articles. Not wanting potential B Corps to be forced to subject themselves to such potential liability, B Lab has provided an alternative to B Corps located in one of the states without a constituency statute (such as California and Delaware). Before becoming a B Corp, the corporation's board of directors must pass a resolution that commits the company to change its articles within 90 days of the passage of constituency legislation.

A B Corp that is not a corporation, such as an LLC, can incorporate B Corp language into its founding documents (such as an operating agreement) regardless of what state it was formed in.

There are a few more steps to becoming a B Corp such as taking a survey to measure the social and environmental performance of the company. To learn more, visit [www.bcorporation.net](http://www.bcorporation.net).

# Other Issues

Securities compliance

Medical Marijuana

(<http://katovichlaw.com/2009/06/27/marijuana/>)

Conversions from one form to another

Combinations of forms

# Interesting Examples

Equal Exchange

Co-op Power

WAGES cooperatives