

How To: Choose an Entity for your Cooperative

A Bite-Sized Legal Guide

Who should use this guide: Worker cooperative member-owners, lawyers and other cooperative technical advisors.

The most common entities for worker-ownership: LLC and Cooperative Corporation

Because the main purpose of most worker-owned businesses is to create economic wellbeing and jobs for their worker-owners, the legal entities they form allow the worker-owners to share in the profits of the business and give each member a vote in the governance of the business. Both the limited liability company (LLC) and the cooperative corporation provide for these options.

- **Cooperative Corporation:** The cooperative corporation is the entity in California that best incorporates the cooperative principles of democratic decision-making and worker-ownership. Each member of the cooperative is required to have a vote for the board of directors and is entitled to share in the profits of the cooperative, if any are distributed, based on the member's "patronage" (i.e., hours worked for the cooperative). Cooperative corporations have to follow certain requirements that are described in the law related to governance, meetings, board of directors, officers and distribution of net earnings.
- **Limited Liability Company (LLC):** LLCs are business entities that have limited liability, but are not subject to the same tax principles and formalities as corporations (including cooperative corporations). They are governed primarily by a contract between all of the members of the business, called the Operating Agreement, which can adopt cooperative principles like "one member, one vote" and profit distributions based on labor-contributions. Because the Operating Agreement is a contract between the members, future members could decide to change the agreement and remove the parts that make it operate like a cooperative, such as governance and profit-sharing based on membership and labor.

How do an LLC and a cooperative corporation differ?

The choice between an LLC and a cooperative corporation depends on each cooperative's specific circumstances. The following are some of the main differences between these two types of entities.

Naming the business



In California, only businesses incorporated under the California Cooperative Corporation Law may use the word “cooperative” in their name. Thus, if you want to include the word “cooperative” in your business’s name, you should incorporate as a cooperative corporation. An LLC may not use the word “cooperative” in its name, but it may use related words like “collective” or “collaborative.”

Employment status

The question of whether cooperative corporation members are employees is a complicated legal issue. Sometimes, however, the members who form a cooperative corporation and work for that cooperative corporation are presumed to be employees. If those members are indeed treated as employees, then they would have to be paid at least minimum wage. The cooperative corporation would also have to comply with other employment requirements, including making payroll tax deductions, issuing W-2s, purchasing workers’ compensation insurance, and paying overtime.

In contrast, the members of an LLC are not generally considered employees. Therefore, a worker-owned business that is formed as an LLC may have more flexibility with respect to minimum wage, overtime, payroll withholding, and workers’ compensation insurance.

Governance structure

The LLC also tends to be more flexible than the cooperative corporation in terms of governance. The rules governing the operation of an LLC are contained in the LLC’s Operating Agreement, which is agreed to by the worker-members of the LLC. The cooperative principles of “one member, one vote” can be written into this Operating Agreement. However, because the Operating Agreement is so flexible, there is a risk that future worker-owners could change and remove the cooperative provisions, unless the Operating Agreement is structured carefully to avoid such possibilities. Conversely, the cooperative corporation has the ideals of “one member, one vote” embedded in its DNA. Although cooperative corporations thus sacrifice some structural flexibility, this bedrock principle ensures that worker-owners will continue to own and control the business. In addition, a cooperative corporation must have a board of directors; an LLC may or may not have a board of directors.

Profit-sharing and taxes

Both the LLC and the cooperative corporation allow for worker-owners to share in the profits of the business. Members of a worker cooperative share in the profits based on “patronage,” which most worker cooperatives measure based on the number of hours each member works. The more “patronage” a member has (for example, the more hours you work), the greater the share of profits to which that member is entitled. Both an LLC and a cooperative corporation could also include other factors such as “job creation” or a “founder’s multiplier” in considering how to distribute profits, based on how the business decides to calculate the value of each worker-owner’s contribution for a given year.



LLCs and cooperative corporations both have tax advantages when compared to other corporate entities, because both are able to avoid double taxation. The profits of typical domestic stock corporations are taxed twice: first at the corporate level, and then again when shareholders receive dividends. However, if it meets the requirements of Subchapter T of the Internal Revenue Code (discussed later in this manual), then a cooperative corporation can avoid double taxation on profits that are derived from members' labor and paid out to the members as patronage distributions.

In comparison, an LLC is generally considered a "pass-through" entity, in which profits and losses are not allocated at the entity level, but directly accounted to the members. However, the tax flexibility involved with an LLC can also result in complex accounting and tax issues in cases of larger LLCs, where members are joining and leaving the organization. This could result in higher administrative costs to manage the organization. Cooperative corporations are somewhat easier to manage when they grow larger because when members leave, the cooperative's bylaw provisions will address how to pay out the member's capital contribution. The member usually does not have a further claim on the cooperative's assets.

There are some other tax differences between LLCs and cooperative corporations, so it's a good idea to check with an accountant familiar with coops to find out if one will serve your business needs better than the other.

Contractor's license

In 2010, California passed a law that allows LLCs to obtain contractor's licenses. However, if you are considering forming a business that requires a contractor's license, the cooperative corporation may be a better option because an LLC must pay higher insurance and bond postings than a corporation.

Which should you choose: LLC or Cooperative Corporation?

Choosing an appropriate entity to carry out your anticipated activities is one of the most important first steps in establishing your cooperative business. The ultimate decision about which legal form to use will depend on specific facts and circumstances about your business plans and long-term goals.

	Cooperative Corporation	Limited Liability Company (LLC)
Ownership	1 or more persons or entities	1 or more persons or entities

Documents necessary to form entity	File Articles of Incorporation with the State	File Articles of Organization
Governance	Statutory requirement of one-member one-vote; must have a board of directors	Flexibility in choosing governance-need not have a board; need not have one-member, one-vote. Can have creative alternative arrangements
Employment status	Working members are likely to be considered employees of the cooperative for immigration and minimum wage purposes	Working members need not be classified as employees, can be classified as "partners"
Management	Corporation's Board of Directors, which may be all members/workers	Can be member-managed or manager-managed
Maintenance document requirements	Need to maintain minutes of meetings and by-laws	Need to draft and comply with an "Operating Agreement"
Lifespan	Unlimited (perpetual) existence, unless dissolved by directors or revoked by state for non-compliance	Can be for a specific agreed-upon time period, or it can be unlimited (perpetual)
Liability	Members' liability is limited to their investment in the corporation	Members are limited to the amount of investment in the company, or as specified in Articles of Organization
Taxation	Corporate taxation. May qualify for subchapter T tax treatment. Subchapter T: corporation taxed on profits, patronage refunds may qualify for federal deductions. Must file corporate income tax return - Form 1120-C	Partnership or corporate taxation. If partnership taxed, then members taxed on share of company income (profits). Taxes paid on personal tax return - Form 1040. If corporate taxed, may qualify for subchapter T tax treatment.

<p>Advantages</p>	<ul style="list-style-type: none"> • Legal entity separate from individuals • Equality of management rights for individual members • Tax deductions may be available • May benefit patrons other than members • Exemption from CA securities qualification for offerings to members (up to \$300) 	<ul style="list-style-type: none"> • Legal entity separate from individuals • More flexible entity for governance purposes • More recognizable entity, thus easier to raise capital than a cooperative • If partnership taxed, then no corporate income tax, but must pay state minimum franchise tax (\$800) • Net operating loss is deductible by members • Less "formal" record-keeping requirements - no need to hold an annual members meeting
<p>Disadvantages</p>	<ul style="list-style-type: none"> • Members are likely to be considered employees for most purposes • Distribution of patronage can get complicated • Must comply with statutory rules around meetings, notice and one-member, one-vote • Difficulty in raising capital • Unfamiliar corporate form 	<ul style="list-style-type: none"> • Profit distributions based on patronage and one-member, one-vote not provided by statute, so future members can change the operating agreement so that the LLC is no longer operating as a cooperative • Cannot raise capital through issuance of stock • Accounting can get complicated with many members in the company, especially if there is high turnover among members
<p>Who finds this the best way to do business?</p>	<ul style="list-style-type: none"> • Owners who see themselves operating on a cooperative business • Desire to use the name "cooperative" • Interested in patronage distributions and flexibility of retaining earnings in the capital account- which may be taxed at a lower rate 	<ul style="list-style-type: none"> • Owners who want flexibility • Don't want to be considered employees • Less traditional cooperative forms- may incorporate outside equity investors • Not available for certain licensed professions

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