Democracy at Work Institute
US FEDERATION OF WORKER COOPERATIVES

Choosing a Business Entity

A Guide for Worker Cooperatives

When forming, worker cooperatives have an important choice to make regarding their legal entity. The business entity types most commonly used by worker cooperatives are the cooperative corporation (which is not available in every state), the limited liability company (LLC), and the C corporation. Worker cooperatives may also choose to operate as an S corporation or general partnership. Each entity type has implications on important issues including taxation, employment law, and access to capital.

Keep in mind that entity choice is not a permanent decision. A worker cooperative may decide to change its entity type as the needs of the business change. This resource is intended to give a brief overview of the entity types and lay out the issues worker cooperatives may want to consider when choosing which is the best fit for the business at whatever stage it is currently in.

Entity Types

- **Cooperative corporations**: Twenty-three states have statutes that enable businesses to incorporate as a cooperative. Some states have worker cooperative specific statutes, while others have a consumer or general cooperative statute that worker cooperatives can incorporate under. These statutes create a corporate form that is owned and controlled by its members, and which operates for their benefit. Statutes vary in their specificity, but often have guidelines around issues such as entity formation, capital accounts, governance rights, membership requirements, and more.
- **C Corporations**: C corporations are business entities that are a separate legal entity—and that are taxed separately—from their owners.
- **S Corporations**: S corporations are very similar to C corporations in that they are a separate legal entity from their owners. However, S corporations elect to pass through their income and losses to their owners for federal tax purposes.
- **General Partnerships**: A general partnership is a business entity with more than one partner (distinguishing it from a sole proprietorship). Each partner contributes to the business and shares in the profits and losses of the business.
- **LLCs**: An LLC is a business entity that provides limited liability to its owners, but has the flexibility to operate like a general partnership. In an LLC, owners are referred to as members.
- **Benefit Corporation**: A benefit corporation is a new class of corporation for socially conscious businesses, which is currently available in more than half of the states as well as the District of

Columbia. Companies that register as a benefit corporation maintain their tax status as a C corporation, S corporation, LLC, etc., but have additional protections and responsibilities relating to their social purpose.

Issues to Consider

Determining which entity type is best for your worker cooperative depends on the character and goals of the business (as well as which entities are available in your state). There are many factors to consider, including the following:

- **Personal liability:** Are owners personally liable in the case of a lawsuit against the business?
- **Entity name**: Can the organization call itself a cooperative?
- **Demutalization**: How easy is it for the organization to revert to a non-cooperative structure?
- **Retaining capital in the business**: How easy is it to retain capital in the business for growth or other purposes?
- **Employment law**: Are workers presumed to be employees under this corporate form, such that labor laws apply? This is especially important in the context of businesses that hat cannot pay minimum wage from the onset or prefer having the staff structured as owners as opposed to employees.
- **Capital access**: To what extent is the business entity friendly to outside investment in a way that maintains cooperative principles?
- **Democratic ownership**: How well is the entity suited to support a democratic ownership structure?
- **Scale and growth**: What issues arise when a worker cooperative incorporated under this entity type experiences significant growth?
- **Entity taxation**: Does the entity get taxed twice (once at the entity level and once through dividends to individual owners)? Is there a minimum annual business tax?
- **Formation costs and requirements**: What are the filing fees and how burdensome are the incorporation requirements?
- **Administrative requirements**: What are the ongoing administrative requirements, such as annual reports, board elections, annual meetings, etc.?

Taxation Elections with LLCs

Worker cooperatives that choose to operate as an LLC have another decision to make—how to be taxed. There are two primary ways to tax an LLC: as a partnership or as a corporation (either a C corporation, S corporation or T corporation).

If the business is taxed as a partnership, the members of the cooperative are taxed on all the profits of the business, including those that stay in the company. While this avoids double taxation and makes for simpler accounting, it also creates a disincentive for re-investment of profits in the company. Additionally, any profits retained in the business are technically owned by individual members, instead of the cooperative itself. As a result, an LLC taxed as a partnership may not be the best choice for cooperatives that have reached a certain stage of growth.

However, the business can move relatively easily between being taxed as partnership versus a corporation or change to another entity type with the help professional advisors. LLCs taxed as a T or S corporation, for example, avoid double taxation, but allow for the flexibility of a membership structure instead of issuing stock. A cooperative may choose to start out as an LLC taxed as a partnership and change its status as it grows.

Worker Cooperative Choice of Entity Chart

Issue area	Cooperative corporations	C Corporations	S Corporations	LLCs (Taxed as a Partnership)	General Partnerships
Personal liability	Members are generally not personally liable.	Shareholders are generally not personally liable.	Shareholders are generally not personally liable.	Members are generally not personally liable.	Partners are personally liable. ⚠
Entity name	States with cooperative statutes generally require incorporation under the statute to use the word "cooperative" in the business name. ✔	Cannot call business a cooperative if a cooperative statute prevents it.	Cannot call business a cooperative if a cooperative statute prevents it.	Cannot call business a cooperative if a cooperative statute prevents it.	Cannot call business a cooperative if a cooperative statute prevents it.
Demutalization	In many states, statute includes disincentives for demutalization. ✔	Must structure a "poison pill" into bylaws to disincentivize demutalization.	Must structure a "poison pill" into bylaws to disincentivize demutalization.	Must structure a "poison pill" into operating agreement to disincentivize demutalization.	There is no separate legal entity from partners. If partners leave, the organization ceases to exist.
Retaining capital in the business	Cooperative orporations can retain capital in the business without tax consequences for worker-members. Retained earnings are taxable at the entity level.	C corporations can retain capital in the business without tax consequences for workers. Retained earnings are taxable at the entity level.	S corporation owners must pay taxes on business income whether it is retained in the business or distributed to them. This makes retaining earnings difficult, although there are work-arounds.	LLC members must pay taxes on business income whether it is retained in the business or allocated/ distributed to them. This makes retaining earnings difficult, although there are work-arounds.	There is no separate legal entity from the partners to retain capital in.
Employment law	Employment law presumed to apply, but this may not always be the case.	Employment law presumed to employ.	Employment law presumed to apply	Employment is not presumed to apply. ✔	Employment law is not presumed to apply.
Capital access	Possible to raise capital through preferred equity depending on cooperative statute. Generally more difficult (or perceived as more difficult) than with a C or S corporation.	Entity type is built to encourage outside investment through stock structure. ✔	Entity type is build to encourage outside investment through stock structure, but has limitations on the number of owners and type of stock that can be issued.	May sell interests, but perceived as not as favorable to capital as C or S corporation structure.	No mechanism for outside investment. Partners provide capital.
Democratic ownership	Form is designed to give members voting/ governance rights that are independent from financial rights. ✔	Can issue multiple classes of stock and unlimited number of shareholders. Can use multiple classes of stock to distribute voting/ governance rights separate from financial rights.	With only one class of stock permitted, financial rights and voting/ governance rights are tied together through stock ownership.	Very flexible structure. May sell interests to outside investors and separate voting/ governance rights from financial rights.	No outside investment mechanism, but partners can structure voting/ governance and financial rights however they please.
Scale and Growth	Growth capital may be difficult, as cooperative corporations are perceived as less friendly to outside investment than stock corporations. However, the structure maintains democratic structure through growth without adjustment to bylaws.	C corporations are easily able to grow. However, democratic structures put in place early may not be sufficient to maintain worker cooperative principles as the company grows. Must revisit and put stronger structures in place.	S corporations only allow one class of stock and a maximum of 100 shareholders. Cooperatives that plan to expand beyond 100 members would have to convert to another entity type (unless using an employee stock ownership plan).	Difficult at a larger scale because income is taxed to individual owners (usually at a higher rate) instead of the corporation. Also perceived as less friendly to investment.	A general partnership would have to form a separate legal entity to scale.
Entity taxation	Entity-level taxation for retained earnings. However, avoids double taxation to some extent, as allocations to members' accounts are not taxed, using Sub-Chapter T tax status.	Double taxed. Taxed both at the entity level and when owners are issued dividends. ⚠	No entity-level tax. Avoids double taxation by passing through income to owners.	As a default, taxed like a general partnership: no entity-level tax, avoids double taxation by passing through income to owners. However, can elect to be taxed as an S, C, or T corporation.	No double taxation, as there is no separate legal entity from the partners.
Formation costs and requirements	State-specific filing fee, must register with the state.	State-specific filing fee, must register with the state.	State-specific filing fee, must register with the state.	State-specific filing fee, must register with the state.	No filing fee, no need to file. ✔
Administrative requirements	State specific requirements that are typically as least as extensive as C or S corporation requirements.	Requirements around the election of board members, annual meetings, annual reports, and more.	Requirements around the election of board members, annual meetings, annual reports, and more.	Minimal administrative requirements. ✔	Minimal administrative requirements.

→ There is no limit on liability for partners in a general partnership. Partners' personal assets are at risk.

→ Cooperative corporations can always be called a cooperative.

→ Cooperative corporations often have long-term cooperative structure built into the form.

→ LLCs are the best form for entities that prefer having owners to employees.

→ C corporations are designed to raise outside capital and have the structure to allow for preferred, non-voting shares.

→ Cooperative corporations are designed for democratic ownership.

→ C corporations are the only entity that is double taxed.

→ Cheapest, least burdensome form in terms of formation.

→ LLCs have very few administrative requirements. They can be great for start-up businesses.