



March 26, 2024

Delegate C. T. Wilson, Chair
House Economic Matters Committee
Room 231
House Office Building
Annapolis, Maryland 21401

**Re: MSBA Business Law Section Council
Senate Bill 85 (Maryland Limited Cooperative Association Act)**

Dear Chair Wilson and Fellow Committee Members:

The Business Law Section Council (the “Section Council”) of the Maryland State Bar Association (the “MSBA”) annually reviews proposed legislation that may affect Maryland businesses. We do so as volunteers generally concerned and interested in the advancement of business entity law in Maryland.

The Section Council provided testimony to the Senate Judicial Proceedings Committee in opposition to SB 085, entitled the “Maryland Limited Cooperative Association Act” (the “MLCAA”), which would enact a new section of the Maryland Limited Liability Company Act. We have carefully reviewed the bill as amended and passed by the Senate. While the hearing and amendment process that occurred in the Senate did address several concerns that we and the Comptroller’s office had expressed, we remain concerned about it and therefore provide this letter to inform your Committee about the legal issues raised by the bill.

We have reviewed all forty-five (45) written submissions to the Senate Judicial Proceedings Committee (aside from our opposition letter), as well as the oral testimony provided by ten (10) witnesses. Most were not legally substantive, in the sense that they spoke in favor of worker-owned businesses generally but were apparently unaware that workers’ cooperatives already can be formed under current Maryland law as limited liability companies (each an “LLC”). Because worker-owned companies can be formed as LLCs, we believe that the legislation is unnecessary and may have dangerous consequences for workers forming a Limited Cooperative Association (an “LCA”).

The Proposed MLCAA May Mislead Workers

A number of the written submissions to the Senate Judicial Proceedings Committee wrongly assume that the proposed MLCAA will clarify the tax classification of workers’ cooperatives. The submission by Nina Themelis, the Director of the Baltimore City Mayor’s Office of Government Relations, is typical in this regard. In her letter, she states:

A cooperative is a business or nonprofit organization owned and operated by the people who either use or provide its services. Currently the Internal Revenue Service provides special rules for taxing cooperatives under Subchapter T of the Internal Revenue Code. However, these rules apply to taxation from the Federal Government. There are already more than 30 worker cooperatives operating in Maryland. Currently in Maryland,

a business entity is taxed as either a pass-through entity or a corporation, making it challenging for Maryland cooperatives to determine their proper tax structure. SB 85 seeks to further define and clarify how worker cooperatives incorporate, pay taxes, get loans, or run their business in compliance with Maryland state law.

This statement is incorrect as to taxes, financing, and legal compliance.

The tax classification of a business entity is determined by federal tax law. Under the proposed MLCAA, a worker's cooperative will be a limited liability company. Under federal law, a limited liability company with more than one member is, by default, a partnership for federal income tax purposes. *See Treas. Reg. §§ 301.7701-2 and 301.7701-3.* An entity can, however, elect to be classified as a corporation. The classification of an entity as a partnership, C corporation, Subchapter S corporation, or a cooperative under Subchapter T is determined solely under federal income tax law. The Maryland income tax classification is governed by the federal tax classification.¹ The proposed MLCCA does nothing to alter this outcome.

One of the individuals who provided oral testimony in favor of SB 85 was Bernardo Vigil of Baltimore Bicycle Works, a workers' cooperative. He testified concerning the difficulties his cooperative faced because the worker members could not be treated as employees for wage withholding purposes. That was because his coop failed to elect to be classified as a corporation. As a consequence, the worker members were classified as partners for federal and state income tax purposes. If an entity is classified as a partnership under federal law, the payments to members are not considered as wages paid to employees and are not subject to federal withholding requirements. *See Treas. Reg. § 301.7701-2(c).*

Mr. Vigil is apparently under the impression that the proposed MLCAA addresses this issue. Not only does the proposed MLCAA not address this issue, but it cannot do so since the determination of the tax classification of an entity is made solely at the federal level. An amendment to the original bill that we advocated for, and was adopted, requires that the organizers of the LCA include in the Cooperative Agreement a statement of whether the LCA will be taxed as a partnership or a corporation, and the ramifications to the members of the tax status elected. Nevertheless, potential organizers of workers' cooperatives may conclude, incorrectly, that, if they organize under the MLCAA, their coop will be classified as a corporation and that worker members will be subject to income tax withholding. If the Cooperative Agreement does not adequately address the tax election and/or subsequently joining worker-members are not made aware of the election, organization as an LCA will not solve the problems raised by Mr. Vigil and others.

The Proposed MLCAA May Strip Workers of Workers Compensation Coverage

Maryland Labor and Employment Code, § 9-206(a) provides as follows:

Subject to subsection (b) of this section, an officer of a corporation or a member of a limited liability company is a covered employee if the officer or member provides a service for the corporation or limited liability company for monetary compensation.

¹ See Maryland Tax General Code, § 10-107 provides that: "To the extent practicable, the Comptroller shall apply the administrative and judicial interpretations of the federal income tax law to the administration of the income tax laws of this State."

Maryland Labor and Employment Code, § 9-206(b)(5) allows individuals who are members of limited liability companies and own “at least 20% of the outstanding interests in profits of the limited liability company” to elect not to be covered by workers’ compensation.

The proposed MLCCA appears to change this outcome. Proposed Section 4A-12A-10(F) of SB 85 now provides that:

(F) (1) the organization of a limited worker cooperative association under this subtitle does not create a presumption that worker members are employees of the association for any purpose.

(2) if a limited worker cooperative association elects to be taxed as a partnership for federal and state income tax purposes,^[2] that election may not be construed to require that a worker member be considered an employee under any state law.

Proposed Section 4A-12A-10(F) of SB 85 purports to address the Workers Compensation issue for worker members, but it does not succeed in doing so. The status of a worker-member as a covered person for workers compensation will not be sufficiently clear.

Reflected in virtually all of the written comments on SB 85 were the assumption that workers’ coops would likely be small businesses engaged in operating restaurants, bicycle repair shops, taxi services, etc. These are precisely the sorts of businesses that involve physical labor and in which the workers tend to have higher rates of physical injury. These workers are among those most in need of the protection provided by workers’ compensation insurance, yet the bill may strip this from many of them.

More broadly, SB 85 does not enable the worker-members of an LCA to identify what their legal rights are, or are not, when joining such an association. They may, or may not, have the rights of employees. They may, or may not, have taxes withheld and paid to the IRS and Comptroller by the LWCA, or they may have to pay estimated taxes as a self-employed individual. In short, despite diligent work by the sponsor and her staff, SB 85 leaves a lot to chance and does not solve the legal problems that animate its supporters. There are no easy legislative solutions to provide clarity on this issue, and so the General Assembly needs to decide whether a statute designed to encourage the greater formation of worker-owned businesses is worth the uncertainty that worker-members, and those financing or supporting them, may have about the employment right of worker-members.

Beyond this large issue, there are some matters left unaddressed in the legislation that may place an LCA in a less advantageous position than an LLC, and thus should also be addressed.

1. Business Law Issues—Alcoholic Beverages and Cannabis

The regulation of the sale and distribution of alcoholic beverages and cannabis is so detailed that it is set forth as a separate article in the Maryland Code. There are undoubtedly many portions that would have to be amended to allow workers’ cooperatives to hold licenses. We would call your attention, for

² As noted above, a workers’ co-op will not “elect” to be taxed as a partnership. That classification is automatic unless the coop elects to be classified as a corporation.

instance, to Alcoholic Beverages and Cannabis Code §§ 3-106 and which address the state and local licensing requirements with respect to a limited liability company.

Workers' cooperatives appear to be very popular forms through which restaurants are organized. The ability to serve alcoholic beverages is often important to the business success of restaurants. Consequently, SB 85 ought to be drafted to assure that workers' cooperatives can obtain licenses to serve alcoholic beverages and the Alcoholic Beverages and Cannabis Code should be appropriately amended.

2. Tax Law Issues—Sales and Excise Taxes Upon Contributions to and Distributions From Workers' Cooperatives

Maryland does not impose a sales tax on contributions to a limited liability company or corporation in exchange for an interest in the LLC or corporation. *Maryland Tax-General Code § 11-209(c)*. It does not apply to certain distributions to a stockholder or a member. *Maryland Tax-General Code § 11-209(b)*.

Similarly it does not impose an excise tax on the transfer of motor vehicles in similar circumstances. *Maryland Transportation Code § 13-810(c)(7)*.

These sections should be amended to extend the exemption to transfers to and from workers' cooperatives. We note that the Comptroller is the agency that will offer comments in this area.

3. Tax Law Issues—Real Property Transfer and Recordation Taxes

There are a number of exemptions from transfer and recordation taxes that apply to various sorts of real estate transactions involving corporations and limited liability companies. See Maryland Tax-Property Code §§ 12-108, 13-207, 13-404, and 13-405. These sections should be amended to extend the exemption to transfers to and from workers' cooperatives.

Conclusion

SB 085 would create a new and distinct form of Maryland business entity. Thus, any provision of the Maryland code that can be affected by the new entity can be modified to accommodate the new entity. In fact, the Maryland LLC Act has been used for over twenty (20) years to form workers' co-ops. We have just not recognized these LLCs as worker co-ops or called them worker co-ops. Thus:

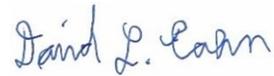
- We've called them law firms, accounting firms, and medical practices in those cases in which capital is not a material income producing factor; and
- We've used LLCs in such businesses as real estate development to allow one stream of return tied to capital contributed and a different stream of return to go to the management team who are the "workers."

In other words, there are detailed road maps to the creation and forming worker co-ops. While SB 85 may encourage the formation of worker coops, it contains numerous traps for the unwary. Organizers will, incorrectly, conclude that problems that they face under current law have been addressed and corrected.

That is not the case, and thus the MLCAA may cause even more problems for the workers that it is intended to empower.

Thus, while the MSBA Business Law Section is not taking a formal position on this bill, we urge the Committee to consider whether the policy objectives underlying it are worth the legal uncertainties that the new business entity will generate for its organizers, members, and third parties with whom the entity interacts – including government agencies and the courts.

Sincerely,

A handwritten signature in blue ink that reads "David L. Cahn".

David L. Cahn
Chair
Business Law Section Council

cc: Business Law Section Council
Senator Mary Washington