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Workers' comp insurance required by state

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Q:**My boyfriend owns several rental properties as well as some vacant land where he plans to build rental homes. He usually employs his relatives or day laborers for the renovation and construction work. Is he required to have any kind of insurance? Personally, I believe he should carry some kind of insurance as protection from personal lawsuits, but we want to hear what you think.**

Uneasy in the East Bay

A: Far be it from me to step into the middle of a lovers' quarrel, but you're right and your boyfriend is definitely wrong.

California law - and the law in many other states - requires virtually every employer to purchase workers' compensation insurance.

It doesn't matter if the workers are your boyfriend's cousins, if he hires them for only a single day or if they are undocumented immigrants working as day laborers. They still need to be covered by workers' comp. (One of the few exceptions is for household help such as babysitters.)

Workers' comp was set up about a century ago to solve the double-edged problem of on-the-job injuries. On the employee side, workers were getting hurt but had no money to pay for medical care. On the employer side, companies faced the risk of endless lawsuits by injured workers seeking redress for their ailments and their medical bills.

So what is your boyfriend risking by going without workers' comp? First of all, there are state penalties. Forgoing workers' comp is a misdemeanor punishable by a fine of up to $10,000 and one year in jail. The state may also issue penalties of up to $100,000 against illegally uninsured employers.

Even more significantly, your boyfriend is opening himself up to potential lawsuits by workers who are injured on his construction sites. If the injuries are severe, your boyfriend could face a six- or seven-figure court judgment.

"One of those (injured) workers is going to have a smart cousin who knows they should have been paying workers' comp," said Mary Thoits, vice president of Thoits Insurance in Santa Cruz.

The other kind of insurance your boyfriend should have is liability coverage. This isn't mandated by law

like workers' comp, but it's a prudent idea.

Suppose some 2-by-4s tumble off the roof of one of his houses and hit a passer-by. Suppose a visitor to the job site trips over some debris and breaks a leg. Your boyfriend could face a lawsuit.

"Say he leaves the gate open and there's a kid playing around on the construction lot," said Bruce Callander, president of Sweet & Baker, a San Francisco insurance brokerage. "As a child, I used to climb through the vents on a house in my neighborhood that was under construction. Imagine a kid gets hurt and the parents sue. If he gets a lawsuit, he'll need (liability insurance) to defend himself and pay."

So what will this all cost your boyfriend?

Liability coverage for his undeveloped properties and construction sites can be relatively affordable.

"You could probably buy a $1 million policy on vacant land for about $500," said Brian McDonnell, senior vice president and director of construction services for ABD Insurance in Redwood City. "For construction, the lower end would probably be $1,500 to $2,000 for $1 million of coverage. That would really be a minimal policy."

Workers' comp coverage, on the other hand, will be pricey.

Standard rates for unskilled carpenters earning less than $24 per hour, for instance, amount to about 28 percent of payroll. "If you have $1,000 worth of payroll, you'd be paying $278 in workers' comp insurance," McDonnell said.

Yow! Those costs are partly why so many building contractors opt to break the law and hire day laborers off the books.

But keep in mind that employers with good safety records are often able to get lower rates. And as costly as workers' comp may be, it's a lot lower than several years ago - thanks to a series of state reforms that have gradually brought prices down.

In 2005, coverage for those same unskilled carpenters would have cost 43 percent of payroll instead of 28 percent of payroll, McDonnell said.

"If it's bad today, it was way worse back then," he said.

Q: My wife and I are planning to start a business selling electric scooters. We'll start by working out of our home. Then if things go well, we will open a retail store. Would an LLC (limited liability company) be the best structure for this business? What are the pros and cons of the various business structures?

S.F. scooter startup

A: The three entities that are probably most appropriate for your scooter sales business are a sole

proprietorship, a limited liability company or an S corporation. In making a choice, consider the following:

-- How much protection from liability do you need? (Do you have a lot of personal assets to protect? And how big a risk of lawsuits is there with your particular kind of business?)

-- How will the entity be taxed?

-- How much paperwork will be involved?

A sole proprietorship is the simplest form of a business, with the least paperwork. The disadvantage is that it provides no liability protection. If someone sues your business, he or she can go after your personal assets as well as business assets.

But you can lower your liability risk with a good insurance policy. So one approach would be to start out as a sole proprietorship, buy insurance, and wait until you're more established to form an LLC or corporation.

"It costs $800 a year to form an LLC in California," said Bruce Coblentz, a senior tax partner with the accounting firm of Armanino McKenna in San Ramon. "That $800 can buy a lot of insurance. So they could save a few bucks by starting as a sole proprietor and once they've gotten going and have scooters on the road, switch to an LLC" or corporation.

Let's say you've decided you need more liability protection than a sole proprietorship can offer. Then you should consider an LLC or an S corporation.

An LLC requires less paperwork than an S corporation. It's a relatively new and increasingly popular structure for many small businesses. But in your case, there's a potential downside - the gross receipts tax levied on LLCs in California.

While S corporations pay a California state tax of 1.5 percent of their net income, LLCs pay a state tax based on their gross sales receipts. So LLCs are not typically a good deal for businesses that have high sales but low or nonexistent profits.

"An LLC is not a good idea for any kind of retail business that is operating with a very small profit margin," said Felicia Vallera, a small-business attorney in San Francisco. "You could end up with a tax liability on your gross receipts, but not have the positive cash flow to pay your taxes."

The gross receipts tax actually varies with the size of your LLC. If you have less than $250,000 in gross sales, you wouldn't have to pay the tax at all. If your sales are between $250,000 and $500,000, you'd have to pay $900 per year. The tax then gradually rises to a maximum of $11,790 for gross receipts over $5 million.

So consider how many scooters you expect to sell in the near future - and whether your tax payments would be lower with an LLC or S corporation. One option is to change structures as your business

grows. "You could start as an LLC, and as your receipts get higher, you may want to switch to an S corporation," Coblentz said.

There's more to this choice than can easily fit in one short column item. You can learn more about California LLCs and the gross receipts tax at *links.sfgate.com/ZBAH*. And several Nolo Press books, such as "Legal Guide for Starting and Running a Small Business," describe the pros and cons of various business entities.

But if you want the best advice for your particular situation, talk to your accountant and attorney.

Small biz events: Some free or low-cost events that can help with your business:

-- On Friday, there's a free workshop in Novato for building contractors - "How to Get Your Bank to Loan You the Money You Need." Sponsors are the Marin Builders Association, Westamerica Bank and Suiter Financial Systems. See *links.sfgate.com/ZBAI*.

-- On Tuesday, the Women's Initiative for Self-Employment will host a daylong conference with seminars on topics such as the art of negotiation and generating sales leads from newspaper articles. The Oakland program is geared to lower-income women entrepreneurs, but is open to all. The cost is $75. See *links.sfgate.com/ZBAJ*.

-- Also on Tuesday, the Alternative Board is sponsoring a $25 morning seminar in San Francisco, "Preparing Your Business for Sale." See *links.sfgate.com/ZBAK*.

Send your small-business questions to Ilana Debare at mindyourbiz@sfchronicle.com, or to Mind Your Business, San Francisco Chronicle, 901 Mission St., San Francisco, CA 94103.

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