

Sy Accountancy Corporation
Member, American Institute of CPAs
704 Mira Monte Place, Pasadena, California 91101
Tel (626) 744-0200, Fax (626) 744-0300, vsy@victorsycpa.com

SHOULD YOU FORM AN LLC?

By Victor Sy, CPA, MBA

A Limited Liability Company (LLC) is a new form of hybrid business association that combines the advantages of a corporation with the flexibility of a partnership. Let's explore the advantages & disadvantages of this popular entity.

Advantages of LLCs:

1. Liabilities are **limited to the equity** invested by each member.
2. It gives some form of **liability protection for each member** unlike general partnerships whose partners are also exposed personally to liabilities of all other partners.
3. There is greater flexibility in management, capital contributions, and distributions.
4. There are liberal membership qualification requirements.
5. It provides for **step-up of a decedent's inside basis** of the member's portion of LLC assets.
6. The liquidation of an LLC is generally treated as a tax-free event.

Disadvantages of LLCs:

1. The statutes on LLCs are relatively new. It is still unclear how Tax Courts will rule on different issues.
2. There is confusion because different states enact different rules.
3. Most states require that LLCs dissolve upon death, retirement, expulsion or bankruptcy of any member unless all remaining members consent to reinstate the LLC.
4. Most states require that an LLC must have two members (as opposed to only one for corporations).
5. **California LLCs must also pay an annual fee** based on the company's gross income. Yes folks, *gross income*. While other states welcome this new type of organization, it seems that California was only forced to adopt LLCs statutes to stop the outflow of business into the neighboring states of Nevada and Arizona. That attitude manifests itself by making this type of entity available but punitive by taxing your gross rents and your sales price when you dispose of it. See updates below.

As you can see, there is a need to plan, a need to balance the **advantage of liability protection against the added burden of an entity fee**. LLCs who check the box to file as partnerships or disregarded entities gain some asset protection benefits but find themselves paying fees than other forms of entity.

Here are some TIPS for you:

1. Instead of having one LLC whose gross revenues exceed \$250,000, set up multiple LLCs to go under the radar.
2. Consider having multiple FLPs with a common LLC that serves as a general partner.
3. Caveat: Be careful **not to trigger a county tax reassessment** when you transfer real estate.
4. One way to avoid reassessments is to **transfer shares inside the LLC**. This also avoids the headache of drawing deeds every time you make a transfer of ownership to the younger generation.

Developments:

1. The LLC annual fee based on total worldwide income was ruled **unconstitutional** by the San Francisco Superior Court. The case involved Northwest LLC that was organized in the state of Washington and registered to do business in California. The California Franchise Tax Board (FTB) assessed the fee on the total worldwide income – without apportionment. The Court ruled that the fee violates the Commerce Clause and the Due Process Clause. If the California FTB appeals the verdict and the fee without apportionment is held to be unconstitutional, only multistate LLCs will benefit from this decision. If the statute itself is ruled invalid, all LLCs that paid the fee will benefit from this decision.
2. The California Board of Equalization ruled that an LLC was doing business in this state simply because the managing member was a California resident. The case involved a **Nevada LLC with a single managing member from California**. The State successfully argued that the performance of managerial functions in California constitutes doing business in this State.