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12 TAXATION BASICS FOR CALIFORNIA LLCs

By Victor Sy, CPA, MBA

LLCs have become the entity of choice for protecting real estate rentals. It has also generated confusion especially in the area of taxation. Let's discuss 12 tax issues for California LLCs and learn about a new kid on the block: the California annual entity fee. See emphasis in blue, recent updates in green.

1. LLCs check the box (choose) to be taxed as partnerships, corporations, or disregarded entities. With this choice comes a host of questions - what forms to file, how to pay taxes and fees.
2. Whatever choice is made, the entity remains the same - an LLC.
3. California LLCs designated as partnerships file Federal Form 1065 and State Form 568. Members receive a 568 K-1 for their share of income and expenses in the entity.
4. California LLCs designated as corporations file Federal Form 1120 and State Form 100.
5. Single member LLCs (SMLLC) are disregarded entities (meaning that you don't file as corporation or partnership). You, the member, merely include items of income and expenses on Schedule C or E of your individual income tax return. California requires you to file State Form 568 (sides one and three only).
6. Husband and wife can choose to file as a partnership or as a disregarded entity.
7. California LLCs filing as corporations or partnerships pay a minimum franchise tax of \$800 per year. This minimum tax is due on the 15th day of the fourth month (April 15 for most entities).
8. And here is a bombshell: California LLCs filing as partnerships or disregarded entity also pay an additional annual entity 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 LLC statutes to stem the tide of businesses moving to Nevada and Arizona.
 - A. \$900 for gross of \$250,000 to less than \$500,000.
 - B. \$2,500 for gross of \$500,000 to less than \$1 million.
 - C. \$6,000 for gross of \$1 million to less than \$5 million.
 - D. \$11,790 for gross of \$5 million or more.
9. Those filing as corporations pay the minimum franchise tax, but *not* the entity fee.
10. Both franchise tax & entity fee are deductible for federal taxation. For state taxation, the franchise tax is not deductible but the entity fee is - as a business expense in Schedule C or Schedule E for disregarded entities or in form 1120 and 1065 for corporate and partnership income tax returns respectively.
11. LLCs initially classified as partnerships or disregarded entities may change classification and elect to be taxed as corporations. Such election must be made for both federal and state classification. Use form 8832 and attach copy to initial California return in the year election is effective.

12. The change to and from corporate taxation is treated as if an actual incorporation or liquidation occurs.

Amidst all these rules and changes, the underlying entity remains an LLC.

Developments:

1. 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.
2. The LLC **annual fee based on gross 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 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 California 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. California is expected to appeal the decision.

TIP - Trust Fund Cases: LLC as Member-Managed or Manager-Managed?

In unpaid payroll cases, IRS goes after responsible persons.

Revenue officers review articles of organization & operating agreement.

O If **member-managed**: IRS goes after **every member** (bad).

O If **manager-managed**: IRS goes after members who are **managers only** (good).

Therefore, it's better to classify new LLCs as manager-managed for payroll tax problems.