

Small Business Clinic

*****This information sheet is intended to highlight certain rules and statutes relating to California LLCs. It is not necessarily inclusive of all required or associated filings, fees or costs and is also subject to change. It is not legal or professional advice, is not intended to be an exhaustive summary or comprehensive in nature and is not a substitute for personalized advice from a knowledgeable lawyer. Because this information is general in nature, it should not be relied upon as complete information regarding any of the matters discussed, but rather, should be used to complement a general understanding of the subject matter. While we hope this information is helpful, we can undertake no responsibility to provide updates to this memorandum. If you require legal assistance, please consult an attorney licensed to practice in your state.***

LIMITED LIABILITY COMPANIES

Structure

- A limited liability company or “LLC” is considered a separate “person” under the law.
- An LLC is owned by its “members.”
- Management
 - An LLC may be “member-managed” or “manager-managed.”
 - Member-Managed: In a member-managed LLC each member has the authority to manage the LLC.
 - Manager-Managed: A manager-managed LLC is managed by one or more managers. The manager may consist of one or more members or even nonmembers.
- An LLC’s members contribute capital (which may include services) in exchange for their membership status.
 - An LLC’s structure is highly flexible: the percentage of ownership in an LLC is not dictated by the amount of capital contributed to the LLC.

Limited Liability

- An LLC’s members are shielded from personal liability for the acts of the LLC assuming that the necessary rules are followed. Such rules include:
 - assuring that the LLC is properly organized (e.g. filing Articles of Organization, adopting an Operating Agreement and making any other required filings);
 - adequately capitalizing the LLC (-- making sure there is enough money in the LLC to operate the business properly); and
 - treating the LLC as a separate entity (e.g. not comingling business funds with



personal funds, separating the LLC's business affairs from the member's personal affairs, not paying personal bills from the LLC's bank account).

- If a third-party wants to hold the members personally liable, the third-party must attempt to "pierce the veil."
 - The third-party must typically show:
 - (1) the LLC and member(s) are not separate; and
 - (2) injustice or fraud will occur if the veil is not pierced.

Distributions

- An LLC's members typically receive funds from the LLC through "distributions" (similar to "dividends" in a corporation), which are distributed to members at the discretion of the LLC.
- Members do not pay tax on the distributions that they receive from the LLC due to "pass through taxation." Instead, the Members are responsible for the tax on the LLC's profits. *See below.*
 - This is different from the way that shareholders of C-corporations are taxed when they receive dividends. Dividends in a C-corporation are subject to "double taxation."

Taxes

Partnership/Disregarded Entity

- By default, an LLC is taxed as a partnership if there are two or more members.
- By default, an LLC with only one member is taxed as a disregarded entity. (Note that the entity is "disregarded" for tax purposes, not for liability purposes.)

Federal Taxes

- The LLC itself does not pay federal tax. Instead, the profits and losses "pass through" to the members, and the members are individually responsible for paying the tax liability. Each member includes his or her share of the LLC's profits (or losses) on his or her individual tax return.
 - This tax must be paid whether or not the profits are retained by the LLC or are distributed to the members in the form of distributions.
 - Often, members will distribute to themselves the money necessary to pay the taxes on the LLC's profits.
- Commencing in 2018, many owners of LLCs (as well as S-corporations, partnerships and sole proprietorships) may be able to deduct 20% of their "Qualified Business Income." The deduction generally applies to taxpayers with taxable incomes under \$157,000 and married taxpayers filing joint returns with income under \$315,000. If a taxpayer's income is over these thresholds, then the question of how and whether the deduction applies becomes very complicated and depends upon factors like whether the business is a specified type of "service business" and the amount of W-2 wages paid by the business. You need to consult a tax advisor about how the new tax law will apply to your business.

- Members do not need to pay additional taxes on the money distributed to them (unlike how shareholders of C-corporations must pay tax on the dividends they receive).

State Taxes

- Each LLC that does business in California is subject to an annual minimum \$800 tax that is due and payable each year (including the LLC's first year). *See below under Filing Fees, Costs & Forms and Necessary Documents.*
- An **additional** tax is required if the LLC has total California revenue of more than \$250,000 per year. If the total revenue is:
 - between \$250,000 – \$500,000 → additional \$900 tax
 - between \$500,000 – \$1,000,000 → additional \$2,500 tax
 - between \$1,000,000 – \$5,000,000 → additional \$6,000 tax
 - greater than \$5,000,000 → additional \$11,790 tax

S-Corporation Taxation

- LLCs may elect to be taxed as an S-corporation instead of as a disregarded entity or partnership.
 - In order to be taxed as an S-Corporation, the LLC:
 - (1) must be organized under the laws of the U.S.;
 - (2) may have 100 member at most, all of whom are individuals and are not non-resident aliens; and
 - (3) may only have one class of ownership interest. (i.e., only one category of membership interest).
- An LLC that elects to be taxed as an S-Corporation would still retain the LLC structure, management and organization. The entity would just pay taxes under the same tax regime as an S-Corporation.

Federal Taxes

- LLCs taxed as S-corporations also have “pass through” taxation. Thus, members are individually responsible for paying the tax liability. The new Federal tax law deduction for Qualified Business Income also applies to S-corporations. (Note that S-corporations are more limited in their ability to alter the percentages of profits and losses that are allocated among owners.)

State Taxes

- Each LLC taxed as an S-Corporation that does business in California is subject to an annual state tax of 1.5% of its net income or \$800, whichever is greater.
 - The \$800 minimum is waived for the entity's first year taxable year; however the 1.5% is not. (For example, if the LLC's income is \$20,000, the state tax will be \$300 (1.5% of \$20,000) for the first year).

California Filing Fees, Costs & Forms and Necessary Documents

- Articles of Organization. An LLC is formed by filing Articles of Organization with the Secretary of State.
 - \$70.00 (plus a \$5.00 Certification Fee). This is usually the cost if the Articles are filed online.)
 - \$30.00 per amendment or restated Articles
 - While most of the time Articles of Organization may be filed online, there may be additional fees if a filing service is used (e.g., \$45 fee for the filing service and a \$15 over-the counter fee if the Articles are filed in person)
- Operating Agreement. Agreement among the members of the LLC that describes the rights, responsibilities and obligations of the members, the business procedures and management of the LLC, and governs the relationship between the members.
 - No Cost – Internal Document
- Statement of Information. Must be filed within 90 days of the LLC's organization and bi-annually thereafter.
 - \$20.00 per filing
- LLC Tax Voucher Form FTB 3522. All California LLCs are subject to an annual minimum \$800 tax that is due on or before the 15th day of the fourth month after the beginning of the taxable year. (For example, if the LLC was formed on March 3rd, the tax is due on or before June 15th.) This document is NOT applicable if the LLC is taxed as an S-corporation.
- Form 2553 (if electing S-corporation status). IRS form to elect S-corporation status. Must be filed by the 15th day of the third month of the taxable year for which the business wants to be taxed as an S-corporation. (This means that if the LLC wants to be taxed as an S-corporation, this Form must be filed within 75 days of the LLC's formation.)
 - No Cost

When to form an LLC

LLCs are often formed when:

- Structural flexibility is preferred.
- Members want to avoid the “double taxation” faced by shareholders of C-corporations and to avoid the limitations of an S-corporation. (For example an LLC may have multiple classes of ownership and pass-through tax status.)
- The entity will own real property.
- Some or all of the members will be contributing services and little or no capital.

S-corporation status is often selected when:

- The business generates higher revenues but lower profits (i.e.: the operating margins are low).
- The business is expecting to make little or no profit in its first year of operation and seeks to avoid the \$800 minimum tax imposed by the Franchise Tax Board and meets the criteria for S-corporation status.