

Legal Risk Management Tip
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CONSIDERATIONS FOR FORMING AND OPERATING A CALIFORNIA LLC: PART 2

In [Part 1](#) of our Considerations for Forming and Operating a California LLC series, we discussed the entity structure of an LLC and initial considerations that should be taken including jurisdiction, the operating agreement and default rules including new rules for formation, duties owed by members, members' authority, ownership interests and indemnification. In Part 2 we will explore tax treatment, other entities, raising capital, and staying compliant.

Choosing Your Tax Treatment

IRS "Default" Classifications

An LLC is extremely flexible in how it may be viewed by the Internal Revenue Service ("IRS") for tax purposes. There are both "default" and "elective" tax statuses available to owners of an LLC. For LLCs with a single owner, the IRS will treat the firm as a sole proprietorship by default, while a multi-member LLC will be treated as a partnership by default. However, the IRS allows LLCs to "elect" a different tax status; namely, owners of an LLC may choose to be taxed in the same manner as either a C corporation or an S corporation (assuming eligibility requirements are met).

Elective Statutes

The elective statuses may not be as good as it seems. For instance, a C corporation is often subject to "double-taxation," whereby the corporation is taxed at two levels. When a firm experiences profits, those profits first are taxed at the corporate level, and then once the remaining profits are distributed to shareholders, those dollars are taxed again to the individual shareholders. Therefore, should an LLC elect to be taxed as a C corporation, the LLC owners may be creating an extra level of taxation on any profits realized.

On the other hand, an S Corporation is not subject to "double taxation" as profits for an S corporation are only taxed at the shareholder level – not at the corporate level. However, by electing S corporation status, the LLC needs to: (1) file a corporate return (which is often expensive), (2) begin doing payroll (even if the only employee is the owner), and (3) may need to pay additional payroll taxes (such as 6.2% employer's portion of social security and the federal unemployment tax). Small businesses in particular should examine the disadvantages of electing to be taxed as S corporation and consider whether it is better to wait until the business is profitable enough to absorb the additional costs.

Other Considerations

Using LLCs as an Ownership Vehicle in Other Entities

Often individuals and business owners will seek to create a legal entity to hold their ownership interests in another entity. Such holding and operating companies act as an asset protection planning strategy that can help limit liability and minimize certain risks. LLCs are popular choices to serve in such roles due to their liability protection, ease of use and flexibility. However, this can be problematic depending upon the type of entity for which the LLC will hold ownership – especially in the case of S corporations. Whereas there is little to no limit on the ability of an S corporation to be a member of an LLC, LLCs can only be members of an S corporation in limited instances. Shareholders of an S corporation can include individuals, certain trusts, and estates, but not partnerships, corporations or non-resident alien shareholders. These strict IRS requirements on S corporations generally exclude many LLCs from owning shares.

A single-member LLC can own shares of an S corporation. However multiple-member LLCs, whether taxed as partnerships or S corporations, may not. The reasoning for this is that a single-member LLC is disregarded for federal tax purposes, so the tax information of the LLC would be reported on the sole owner's personal income tax return, just as it would if the individual personally owned the stock.

Raising Capital

An LLC has the same two general sources of capital as does a large corporation: equity and debt. However, it can often be a challenge to convince the sources of capital available that investing in an LLC is a good investment. There certainly are advantages to investing in an LLC. Namely, the flexibility of LLCs allow the firm to structure the ownership rights of new members (any new investor would be deemed a new “member”) in any way that meets the needs of the business. The LLC can specify, as part of its operating agreement, how much or little say the new member will have in the management of the business. The new member's share of the profits also can be specified and set up differently than for other members.

However, it may still be more difficult to raise financial capital for an LLC as investors may be more comfortable investing funds in more commonly known and recognized corporate forms. Further, the tax laws that govern non-profits (such as pension funds) that often invest in venture capital funds make it difficult for those funds to invest in LLCs. Professional investors generally prefer the more freely transferable stocks of a corporation as opposed to membership interests in an LLC which are often restricted in some manner. Finally, professional investors are looking primarily to a sale of the company or an Initial Public Offering which are, almost without exception, conducted via C-corporations.

Keeping Your LLC Compliant

Biennial SOI Filings

In California, per the California Code of Regulations, every domestic and registered foreign LLC shall file a Statement of Information with the Secretary of State, within 90 days after the filing of its original Articles of Organization or Application for Registration, and biennially thereafter during the applicable filing period. The applicable filing period for a limited liability company is the calendar month during which its original Articles of Organization or Application for Registration were filed and the immediately preceding five calendar months. A limited liability company is required to file this statement even though it may not be actively engaged in business at the time this statement is due. Changes to information contained in a previously filed statement can be made by filing a new form, completed in its entirety.

Annual Tax

LLCs classified as a disregarded entity or as a partnership for tax purposes are subject to an annual tax in the state of California. LLCs that are organized or registered in California are subject to this annual tax even if the LLC conducts no business in California. Thus, it is important to note that even if you have a “shell” LLC that is not currently conducting business, the annual tax still applies. This is a common mistake for those who establish an LLC, but don’t necessarily perform business the first few years of its existence. Once taxes are assessed, all previously owed annual taxes become due as well.

Commingling Accounts

As noted above, one of the main reasons for forming an LLC is to protect the members’ personal assets from business liabilities. Commingling of personal and business income and expenses can lead to a loss in this liability protection. This is a common mistake, especially in small businesses, when there may not be a lot of money coming in, so owners simply share their personal bank account with the LLC. It is important to distinguish between the two such that deposits and expenses of the LLC are made to a separate account, and the LLC is treated separate and distinct from the members’ personal account(s).

Conclusion

The items discussed as part of this series are by no means an exhaustive list of all matters that should be considered when forming and/or operating an LLC. Depending upon the particular business model of the LLC, there may be additional accounting, tax and legal matters that require consideration. While there are distinct advantages to forming an LLC in certain situations, it should not be perceived as the best choice in every situation. It is best to consult with an attorney, accountant and/or other professionals familiar with the rules and regulations surrounding LLCs prior to formation. Doing so will help to ensure the business operates properly and provides those benefits most desired by the company.

For more information on this topic, please contact us at (619) 298-2880 or at info@jackolg.com.

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