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## TAXATION OF LIMITED LIABILITY COMPANIES

*(Business Advisory No. 1)*

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This Advisory highlights important Federal and California state tax consequences that apply to the formation, operation, transfer and dissolution of a limited liability company (Company) in California. The tax consequences associated with each of these phases of a company's life significantly impacts both your Company and its members and may influence your business and financial decisions.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the mere distribution of this Advisory.

**Tax Consequences on Organization.** In general, your Company will not be taxed on the receipt of capital contributions from its members, whether in the form of cash, property or services. However, members may be individually taxed depending on the nature of their contribution. Members who contribute cash in exchange for a membership interest will not be taxed on the property contribution. Likewise, members who contribute property to the Company generally will not be taxed on their property contribution. However, members who contribute property subject to a liability may have to recognize gain to the extent the liability exceeds the sum of (1) the member's basis in the contributed property plus (2) the member's basis in the Company before the contribution. In some circumstances the contribution of property may be recharacterized as a sale to the Company, in which case any gain on the sale would be taxed to the member. Also, the contribution of marketable securities may result in the recognition of gain.

Members who contribute services generally will not be taxed on receipt of a profit interest. However, a capital interest received by a member in exchange for services will be taxed as income to the member. It is important to analyze these tax consequences upon formation of your LLC, so that a belated tax audit/bill does not arrive and cause havoc with the LLC or its members.

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**Taxation of Income from Operations.** Unless a written election is made otherwise, limited liability companies are taxed as a partnership. Single member LLCs, in fact, are considered “disregarded entities” for tax purposes, with their income and expenses included in the member’s individual income tax return. Therefore, the profits and losses of the Company typically “flow through” to the members and are not taxed at the company level. However, a limited liability company may elect to be taxed as a corporation, in which case income will be subject to taxation at the company level. Members would then pay an additional tax upon the receipt of distributions, unless a “S” tax election is made. If such an election is made, the “s” tax consequences apply. Because of franchise tax and corporate taxation, a conversion into a corporation might be appropriate rather than this circulatory route.

Assuming that your Company will be taxed as a partnership (the usual election), the Company will not be subject to tax at the federal level. The Company also will not be subject to tax in California except for payment of an annual minimum franchise tax of \$800 as well as an annual fee based on the Company’s total income (gross revenues) as set forth in the following table:

| <b>Total Income</b>                  | <b>Amount of Tax</b> |
|--------------------------------------|----------------------|
| Less than \$250,000                  | 0                    |
| \$250,000 to less than \$500,000     | \$900                |
| \$500,000 to less than \$1,000,000   | \$2,500              |
| \$1,000,000 to less than \$5,000,000 | \$6,000              |
| \$5,000,000 or more                  | \$11,790             |

As a “flow through” entity, income and losses of your company will be allocated to its members. Company losses may be deducted by the members (but not in excess of their respective bases of their interest/membership in the Company) subject to the at-risk and passive loss rules of Internal Revenue Code, Sections 465 and 469. In general, the Company may make special allocations of profit, loss, deductions and credits to its members as long as the allocations have “substantial economic effect.”

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**Taxation on Transfers of Membership Interests** 1. In the event a membership interest is transferred, the Company is generally not taxed on the transfer of a membership interest. However, in the event more than 50% of the profit and capital interests are transferred within a twelve month period, the transfer will be treated as though the Company were dissolved and subsequently re-organized.

The transferring member will be taxed to the extent the amount received by the member exceeds that member's basis in the membership interest. The gain or loss resulting from the transfer will generally be considered a capital gain or loss.

**Taxation on Liquidation of Company.** As in the case of transfers of membership interests, there will generally be no tax at the company level upon dissolution. Any cash or property received by the members following the dissolution will be taxed to the extent the value of such cash or other property exceeds the members' bases in their respective membership interests. Any gains or losses are generally treated as capital gains and losses.

The discussion in this Advisory is intended to familiarize you with the general tax rules applicable to your Company and its members and to assist you in making decisions with respect to capitalizing the Company and conducting its future business operations. However, the application of these rules to specific transactions may have different consequences depending on the facts involved, and we recommend that you obtain a more detailed analysis of the tax consequences which will arise with respect to particular transactions. Should you wish to discuss any of these matters further, please do not hesitate to call.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. You should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

S. Timothy Buynak  
Business and Tax Attorney

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*This Advisory is one of a series of business and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.*

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1. Cal. Tax & Rev. Code §17942.



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*Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and non-profit organizations from entity formation and start-up, through day-to-day operations and exit strategies.*

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