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CALIFORNIA'S LIMITED LIABILITY COMPANY ANNUAL FEE AND THE TAXATION OF MULTIPLE ENTITIES

(Business Advisory No. 5)

California has established permanent tax rates for limited liability companies (LLCs). These rates are imposed upon the annual income of LLCs. This taxing structure may be beneficial to you when compared to California's corporate tax structure, depending upon the income "step" of your entity and its profit. California's corporate taxes, whether a "C" or an "S" corporation, are based on the profit of the entity; the LLC tax is based on gross income. See Business Advisory No. 6 for a comparison of the relative attributes and detriments of corporations, limited liability companies, and partnerships and Tax Advisory No. 4 for a comparison of the relative taxes of such entities based on certain income and profit levels.

The LLC structure may also be beneficial since California has eliminated the "double tax" in parent-subsidiary LLC structures. In the parent-subsidiary structure, income of the subsidiary that has already been taxed is exempt from taxation at the parent level.

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.

LLC Tax Structure. Ever since their introduction to California, LLCs have been an increasingly popular means by which to conduct business. LLCs combine the traditional benefits of corporations (liability protection) and partnerships (flow-through tax treatment) while avoiding their respective detriments (operating and management formalities, entity level taxation and an owner's personal liability). While other types of entities (such as S corporations or limited partnerships) may present benefits similar to an LLC, those entities are subject to certain potentially significant limitations and often do not provide the same level of flexibility as an LLC.

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Traditionally, one of the greatest limiting factors in selecting LLCs has been California's annual fee based upon the LLC's total income.[1] Depending on the circumstances, the amount of the annual fee could be greater than taxes assessed against other types of entities, especially an "S" corporation.[2]

1. "Total Income" and Annual Fee Amount. The amount of California's annual fee is determined by the LLC's "total income", which is comparable to its gross revenues.[3] The fee is a fixed amount based upon specified income tiers, as set forth in the following table.[4]

If the total income is:	**The fee amount is:**
$250,000 – $499,000...........	$900
$500,000 – $999,999..........	$2,500
$1,000,000 – $4,999,999.....	$6,000
$5,000,000 or more	$11,790

2. Double Taxation. Until recently, due to the flow-through tax treatment typical of limited liability companies, tiered LLC structures were subject to double taxation because the income of a subsidiary LLC would also be included in the total income of a parent LLC. The

[1] California also imposes a minimum franchise tax of $800.00 per year for the privilege of doing business as a limited liability company and LLCs are not allowed to render services for which a license is required by the Business and Professions Code.

[2] See Tax Advisory No. 4 comparing the relative taxes of corporations ("C" & "S") and LLCs.

[3] "Total income" means gross income (as defined in California Revenue & Taxation Code, Section 24271) plus the cost of goods sold that are paid or incurred in connection with the LLC's trade or business. California Revenue & Taxation Code, Section 24271 incorporates Internal Revenue Code, Section 61 as its definition of gross income.

[4] Because the LLC annual fee is based upon "total income" and not "net income", it is possible that an LLC would be subject to a greater tax in California than an S corporation. For example, assume that an LLC has a "total income" of $1,500,000. Based on the above table, the LLC would pay an annual fee to California of $6,000. Now, assume that the LLC is an S corporation with a "net income" of $300,000 (representing a 20% profit margin). This S corporation would pay an entity level tax in California of $4,500 (1.5% of $300,000). In this scenario, an S corporation will pay less tax than an LLC due to its ability to offset certain expenses and other deductions against its income. Whether a particular LLC's annual fee will be more or less than a comparable S corporation's entity level tax will depend on the entity's underlying finances and profitability. See Tax Advisory No. 4. As for limited partnerships, California does not impose any tax or other fee at the entity level, but must still pay a franchise fee of $800.

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annual fee would then be assessed against the same income at both the parent and subsidiary level. Legislation modified this aspect of the annual fee by excluding from the definition of total income, any "allocation or attribution of income or gain or distributions made to a limited liability company in its capacity as a member of, or holder of an economic interest in, another limited liability company if the allocation or attribution of income or gain or distributions are directly or indirectly attributable to income that is subject to the payment of the [annual fee]."

This change in the definition of "total income" clearly reduces the overall tax imposed upon LLCs involved in a tiered, parent-subsidiary organizational structure, thereby making LLCs relatively more attractive in a multi-tier structure compared to other forms of entities than before the statutory amendment.

Strategies for Modifying Existing Entity Structures. With AB 898's modification of the annual fee statute, there is no longer a disincentive to creating tiered LLC structures. Moreover, because the "total income" exclusion is not likely to apply to non-distribution income between "brother-sister" LLCs, there may be an incentive to restructure such organizations into a tiered, "parent-subsidiary" structure.

Recognizing that "brother-sister" LLC and non-LLC organization structures may have been preferred in the past and that AB 898 will now make "parent-subsidiary" LLC structures more preferable in certain circumstances, it may be beneficial to modify existing entity structures into tiered, parent-subsidiary LLC systems. Some strategies and other considerations related to such a transformation are described below.

1. Formation of Parent LLC. While "series" LLCs are not yet authorized in California, for existing "brother-sister" entity structures, a new LLC could be formed to act as the parent to all existing entities. This alternative could simplify the ownership/management structure by creating a single LLC that would be responsible for management and operation of all subsidiary entities. Assuming the parent LLC becomes the sole member of the subsidiary LLCs, this structure could also reduce administrative expenses because single member LLCs are disregarded entities for tax purposes at both the federal and state level (except each LLC will be subject to California's annual $800 minimum franchise tax).

2. Conversion to LLCs. For organizational structures that consist of non-LLC entities, it is possible to convert[5] these entities into LLCs. Such transactions may expose the

[5] A "conversion" is a change in the legal structure of a business entity in which the entity ceases to be the type of entity it was before (e.g., a limited partnership) and becomes a different type of entity (e.g., a limited liability company) while continuing its existence as the original entity for all other purposes. Limited partnership conversions are authorized by Article 7.4 (commencing with section 15677.1), Chapter 3, Title 2 of the California Corporations Code. Specifically, for converting a limited partnership to an LLC, the Code requires that each of the

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entities' owners to some liability risks and adverse tax consequences, so care is required. In the end, the transaction costs of completing the conversion should be compared with the long-run savings in annual fees.

3. Minimize Contract Payments. Even if it would be impractical to modify an existing LLC structure into a tiered, "parent-subsidiary" structure, another option for reducing overall annual fees would be to minimize the amount of any contractual payments between the related LLCs. This would minimize the income of each LLC, thereby reducing the respective annual fees.

4. Caveat: Maintain Diversification of Liabilities. Assuming that reorganizing an entity structure into a tiered system will provide annual fee benefits, consideration must be given to ensure that the reorganization does not eliminate the existing structure's benefits derived from diversifying each entity's liabilities. For example, under a tiered structure, creditors of a parent entity can acquire access to or control of a subsidiary's assets. Therefore, it is important to avoid placing entities exposed to liability into a parent relationship to other entities. Again, California does not allow "series" limited liability companies. In an appropriate situation, an out-of-state series limited liability company might be considered and then registered to do business in California, which California will recognize.

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partners of the converting limited partnership receive a percentage interest in profits and capital of the converted entity equal to that partner's percentage interest in profits and capital of the converting limited partnership as of the effective date of the conversion. (Cal. Corp. Code § 15677.2) The Code does not address, and the courts do not appear to have resolved, whether the statutory requirements are satisfied when the underlying ownership interests in the entities involved in the conversion remain the same even though the direct ownership interests have changed. For example, if LLC Z, as the general partner of limited partnerships X and Y, owns 10% of the profits and capital of X and Y with the remainder owned by individual limited partners A and B, Z must own 10%, and A and B must each own 45%, of the profits and capital of each entity upon their conversions to LLCs. However, assume that A and B each own 50% of Z and that the only purpose for forming Z was to serve as the general partner of X and Y, thereby protecting A and B from personal liability. In pursuing the conversion, A and B may wish to have Z become the sole member of LLCs X and Y in order to consolidate their responsibility for management and operation of X and Y through Z. In this case, although A and B would each own 50% of the profits and capital of X and Y before and after the conversion, both directly and indirectly through Z, the direct ownership interests would have changed. Alternatively, A and B may wish to become 50% members of LLCs X and Y in order to eliminate the minimum franchise tax and administrative expenses associated with Z. In this case, A and B would each own 50% of the profits and capital of X and Y before and after the conversion, again both directly and indirectly through Z. However, as with the previous scenario, the direct ownership interests would have changed through the conversion. It is unknown whether these indirect or "pass through" interests will be recognized for purposes of the statutory requirements.

Even if such "pass through" interests do not satisfy the statutory conversion requirements, the same structure could be achieved independent of the conversion procedures. However, such transactions may subject A and B to some level of personal liability (potentially negligible) or cause unfavorable tax consequences.

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As always, before implementing any of these strategies, 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. Our representation is only undertaken through a written engagement letter and not by the distribution of this advisory. You should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

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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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