



BUYNAK & FAUVER

TAX REPORTING REQUIREMENTS FOR SINGLE MEMBER LIMITED LIABILITY COMPANIES

(Tax Advisory No. 2)

Limited liability companies (LLCs) have become a popular means by which to conduct business and own property. LLCs have traditionally owed this popularity in part to their treatment as a partnership for tax purposes that allows the LLC income and losses to flow-through to its members. Single member LLCs provides additional benefits by simplifying the tax reporting requirements for such LLCs and thereby reducing the administrative costs associated with the entity. This memorandum summarizes the federal and California tax reporting requirements for single member LLCs.

This memorandum is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney and/or accountant. Our representation is only undertaken through a written engagement letter and not by the distribution of this advisory. While we maintain an office in Santa Barbara, Lana Clark, a long time Solvang resident and experienced business and estate planning attorney, can meet with you at a Santa Ynez Valley location to discuss your legal needs upon request.

Background. 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 personal liability of the owner). This combination makes LLCs a particularly attractive option for many businesses, property owners and for other purposes.

From a tax standpoint, most (if not all) states charge an annual fee for the right to be organized or to conduct business in the state, and some states, such as California, assess a charge based upon an LLC's income.

Under the Internal Revenue Service's "check the box" rules, LLCs were traditionally considered a partnership for tax purposes.¹ With the advent of single member LLCs,² these entities fall

¹ Single member entities may elect to be taxed as a corporation by filing IRS form 8832.

² Care should be undertaken in the formation of your limited liability company if you want to qualify as a single member LLC and therefore become a "disregarded" entity for tax filing purposes.



into a new category such that they are generally disregarded as an entity separate from its member.³ As a disregarded entity, an LLC provides simplified tax reporting requirements that lead to lower administrative costs compared to multiple member LLCs, as summarized below.

Federal Taxes. At the federal level, the LLC is disregarded and need not file a return. Income from these entities is to be reported on one of the following forms:

Individual Member. An individual member will file IRS form 1040. The LLC income is reported either on Schedule C, E or F (farm related income). Schedule C is used for passive income, including rental real estate (in which no significant services are provided). Amounts from Schedule E are reported on Form 1040, line 17.

Partnership (including multiple member LLC) Member. A partnership member will file IRS form 1065. Depending on the nature of the business, the LLC income would be reported either on line 1 (gross receipts or sales), line 4 (ordinary income from other partnerships, estates and trusts) or line 7 (other income).

Corporate Member. A corporate member will file its IRS form 1120. Depending on the nature of the business, the LLC income would be reported either on line 1 (gross receipts less returns and allowances), line 4 (dividends, from Schedule C) or line 10 (other income).

California Taxes. In California, while the LLC is generally disregarded for tax purposes, the LLC is still subject to the annual franchise tax and the gross receipts tax. Therefore, all LLCs must file Franchise Tax Board form 568. However, a single member LLC only needs to complete side 1 and side 3 (Schedule K). To complete side 1, the LLC must also complete and attach the Limited Liability Company Income Worksheet, which in turn requires completion of Schedule B. Line 2 of side 1 accounts for the LLC's gross receipts tax. The LLC will also identify on side 1 the type of return that will be filed by its member. Consequently, the LLC's income will typically be reported on Form 540 (individual member), Form 100 (corporate member), Form 565 (partnership member) or Form 568

³ A recent IRS internal memorandum (ILM 200235023) suggests one potential disadvantage to disregarded single member LLCs. The memorandum concludes that the member of such an LLC will be liable for both the income and employment taxes attributable to the LLC. As a result, the member loses the liability protection otherwise afforded by the LLC to the extent of the tax. In this respect, a disregarded single member LLC is at a disadvantage compared to multiple member LLCs and LLCs electing to be taxed as a corporation whose members, according to the IRS memorandum, will not be liable for payment of employment taxes. Although the memorandum cannot be cited as a precedent, it provides insight into the position that the IRS maintains on this issue.

A similar disadvantage attributable to single member LLCs was demonstrated in a bankruptcy case from Colorado, *In re Ashley Albright*, 2003 Banker LEXIS 291 (Bkrptcy. Colo. No. 01-11367 ABC, Apr. 4, 2003). In this case, the debtor owned real property as a single member LLC. The bankruptcy court allowed the trustee to take control of the LLC to sell its assets for the benefits of the single member's creditors. This decision deviated from the traditional rule that limited the remedy of creditors of a partner or LLC member to a charging order. This decision presents another situation in which a single member LLC may be less advantageous than a multiple member LLC.



(limited liability company member). The annual franchise tax must be accompanied by form 3522 and paid by the 15th day of the 4th month of the LLC's fiscal year.

Tax Identification Number. Most entities, including LLCs, obtain a Tax Identification Number for purposes such as reporting employment taxes and obtaining bank accounts.⁴ The identification number is one aspect in which the entity is distinguished from its owners. The California Secretary of State also assigns its own entity number for LLCs when the Articles of Organization are filed.

Single member disregarded LLCs have the option to either obtain a separate identification number or utilize the identification number of its owner. Utilizing the owner's identification number may be advantageous in the event the LLC does not have any employees because, once a separate identification number is acquired, the IRS will typically expect the LLC to file employment tax returns. The disregarded LLC can avoid this additional scrutiny from the IRS by not acquiring a separate identification number.

Once the disregarded LLC obtains employees, it may wish to acquire a separate identification number in order to account for and report the taxes of its own employees apart from those of its owner's other businesses or entities. Doing so will not prevent the LLC from reporting these taxes on its owner's identification number at a later date. However, once these tax obligations are reported on the owner's identification number, the disregarded LLC cannot later report such taxes on a separate identification number.

Husband and Wife as Member(s). Since the introduction of single member LLCs, there has been confusion as to whether a husband and wife who owned the entire interest of an LLC as community property qualify a single member. In order to provide some guidance in this area, the IRS adopted Revenue Procedure 2002-69. This procedure will apply to an entity if: (1) the entity is wholly owned by a husband and wife as community property under the laws of a state, foreign country, or possession of the United States; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the entity is not treated as a corporation under IRS Regulation Section 301.7702-2.⁵ In these situations, the IRS will respect the husband and wife's treatment of the entity as either a disregarded entity or partnership for federal tax purposes. However, the IRS will treat any change in the reporting position by the husband and wife as a conversion of the entity.

California has also adopted Revenue Procedure 2002-69, so a husband and wife entity in California who own their LLC membership as community property are classified as a single member LLC and is a disregarded entity for tax purposes.

⁴ Identification numbers are obtained from the Internal Revenue Service by filing Form SS-4.

⁵ Regulation Section 301.7702-2 generally defines corporations as an entity organized as a corporation under federal or state law, joint stock companies, insurance companies, banks, entities wholly owned by a state or any political subdivision thereof, certain entities taxable as a corporation and certain foreign entities.



Husband and Wife Revocable Trusts. Although revocable trusts are disregarded for tax reporting purposes, the usual husband and wife revocable trusts and/or their estate planning qualify as a single member LLC.

Conclusion. Single member LLCs possess many advantages, including simplified tax-reporting procedures. To recognize these advantages it is important to properly form, maintain and report your LLC to taxing authorities.

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. If you have questions or concerns, you should discuss your individual situation with us or your own attorney.

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

The Buynak & Fauver Law Firm provides business legal services to individuals, business entities and nonprofit organizations from entity formation and start-up, through day-to-day operations and exit strategies.