

M e m o r a n d u m

To: Mr. David Gau, Chief
Policy, Planning and Standards

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From: Kristine Cazadd
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Subject: *Single-Member LLCs*

This is an analysis of the change in ownership consequences relevant to recent legislation, AB 831 (Leach) Stats. 1999, Ch. 490, that authorizes legal entities in California to organize as single-member LLCs. The issues addressed here are three-fold. First, should single-member LLCs be treated for property tax purposes as legal entities separate and distinct from their sole owner/member? Secondly, are transfers of the member's interests in a single-member LLC calculated in the same manner as partnership interests under Rule 462.180 (d)? Thirdly, does the ability of the member/owner of a single-member LLC to report the LLC's income and losses on individual tax returns affect LEOP's ability to track changes in control and ownership? For the reasons explained, the answer to the first two questions is yes, and the third question is no.

1. Single-Member LLCs are legal entities separate from their owners.

The Beverly-Killea Limited Liability Company Act of 1994¹ authorized the formation of LLCs in California. An LLC is a hybrid form of legal entity that combines the liability protection of a corporation with the tax benefits of being treated as a partnership. Thus, the owners, called "*members*", of the LLC are protected from personal liability for the entity's debts, while their tax treatment as a partnership provides the advantages of "*pass-through*" taxation. Simply defined, "*pass through*" means that for federal income tax purposes, the owners of an LLC, partnership, or limited partnership may, after filing a partnership tax return, pass through their shares of the entity's income or losses to their own individual tax returns (based on the amounts reflected on Schedule K-1).

Until the passage of AB 831, the Act has required that an LLC must have two or more members.² The legislative change, codified in Corporations Code Sections 17001, 17050, and 17101, authorizes a single individual or entity to form an LLC. The major difference between a two-member LLC and a single-member LLC is that a single-member LLC may choose to be treated as a "*disregarded entity*", under federal tax law *disregarded as an entity separate from its owner*. To be a *disregarded entity* means that the owner reports the LLC's income or losses directly on his/her individual federal tax returns, and the

¹ California Corporations Code Sections 17000 et seq.

² A "member" may include an individual, general or limited partnership, a trust, a corporation, or other LLCs.

entity, for federal tax reporting purposes, *does not exist*, and therefore, does not need to file a return.

This treatment is made possible through federal tax laws called “*check-the-box-regulations*” which provide that any LLC, partnership, or limited partnership may choose to be taxed as a partnership, corporation, sole proprietorship, or a division or branch of its owner.³ For single-member LLCs however, the “check-the-box” regulations provide that unless an LLC chooses to be taxed as a corporation, it will be automatically treated as a disregarded entity.

Recent legislative changes conformed California’s tax law to the federal “check-the-box” regulations, allowing entities filing with FTB the same choice on their state tax returns, with two important exceptions. First, California entities are required to use the same “classification” for reporting in California as they indicate for federal tax purposes. That is, if an LLC is taxed as a partnership for federal purposes, it will be taxed as a partnership for state purposes. Secondly, even though a single-member entity is disregarded, it must still file an LLC tax return (FTB Form 568) in California, and pay the \$800 annual franchise tax, and pay the LLC gross receipts fee,⁴ per Revenue and Taxation Code Section 18633.5 (i).

To form any LLC in California, whether single-member or other, requires that the LLC file “articles of organization” with the Secretary of State and enter into an “operating agreement.”⁵ Under Corporations Code Section 17050(c), the existence of an LLC begins upon the filing of the articles of organization. A copy of the articles, certified by the Secretary of State, is conclusive evidence of the formation of the LLC and prima facie evidence of its existence. An “operating agreement” means any written or oral agreement between all members as to the affairs of the LLC and the conduct of its business. (Corporations Code Section 17001(ab).) Although oral agreements are permitted, the burden is on the taxpayer to prove the “separateness” of the LLC as an entity distinct from the individual owner. There is no requirement to recognize the separate existence of a single-member LLC if the owner disregarded the statutory formalities of properly forming it.

In summary of the foregoing, a single-member LLC must be treated as a separate legal entity for property tax purposes, with transfers of membership interests in the LLC subject to the provisions of Section 64(a) et seq. Similarly, transfers of real property to or from a

³ As a general rule, the “check-the-box” regulations do not apply to entities formed prior to January 1, 1997. Treasury Regulation Section 301.7701.

⁴ Revenue and Taxation Code Section 23038(b).

⁵ Under Corporations Code Section 17050(a), the operating agreement may be entered into before or after the filing of the articles with the Secretary of State. The persons who execute and file the articles need not be the members of the LLC.

single-member LLC are changes in ownership of the interests transferred, unless the transfers are excluded under a specific statutory provision. Even though the single-member LLC may be *disregarded* and its profits and losses reported on the individual member's tax return, its affairs are governed by all of the formalities imposed on all other legal entities (e. g., corporations, partnerships, etc.). Its articles of organization and its operating agreement determine who the members are, the extent of the interests they own, the activities it conducts, and the terms of its future dissolution. And as noted above, an LLC acquires its separate existence as a legal entity once its articles of organization are filed and its operating agreement executed. How its federal or state income taxes are reported on various returns has no bearing on the legal recognition of a properly formed LLC (single-member or other).

2. Transfers of interests in a single-member LLC are calculated in the same manner as transfers of partnership interests under Rule 462.180 (d).

As noted above, an LLC with two or more members must file an election to be taxed as a corporation, or it will be automatically treated as a partnership, and a single-member LLC will automatically be a disregarded entity unless it elects otherwise. Under property tax statutes, an LLC with two or more members is treated as a partnership. In defining "ownership" in a limited or general partnership, Section 64 and Rule 462.180 (d)(1)(B) provide that an "ownership interest" in a partnership constitutes "the total interests in both partnership capital and profits,"⁶ based on the terms of the agreement. Thus, partners may acquire specific shares or interests in the profits and losses, or in the partnership capital in return for his/her contribution, and may allocate among themselves, as well as prioritize, the distribution of profits, return of capital, or any other matter. (Corp. Code §15653.) Distributions of capital and profits from the partnership to the partners must follow the terms of the partnership agreement, and if the terms do not otherwise provide, distributions which are a return of capital shall be made in proportion to the contributions of each partner. Distributions which are not a return of capital shall be made in proportion to the allocation of profits. (Corp. Code §15654.)

These principles apply in exactly the same manner to LLCs with two or more members and to single-member LLCs. That is, the character and percentage of the member's capital and profits interests in a single-member LLC are based on the terms of the operating agreement, and the language of a particular agreement is controlling. For example, if the terms of the "LLC A Agreement" provide that the sole member is A with 100 percent of the capital and profits, then A alone and no one else has a right to share in either the LLC's capital or profits accounts. None

⁶ While there are no definitions of "capital" or "profits" in the property tax rules or the statutes, a "capital" interest in a partnership is described for income tax purposes, as any interest in the assets (partnership property, cash, assets) to which any partner is entitled upon his withdrawal from the partnership, or upon the liquidation of the partnership. This "capital interest" is distinguished from the right to participate in the earnings, profits, and losses of the partnership. (Treasury Regulation Sec. 1.704-1(e).)

of LLC A's interests or real property can be attributed to anyone else for purposes of determining the change in ownership consequences. If single-member LLC A therefore, transfers interests or property to A as an individual, the transfer is excluded under the proportional interest exclusion in Section 62(a)(2). If LLC A transfers interests or property to any other person or entity, a change in ownership results unless an exclusion applies. In some situations, a single-member LLC that owns real property may be solely owned by a corporation or another LLC. As such, "Sub-LLC" is treated as a branch or division of the parent for income tax purposes, and may be eligible to participate in tax-free reorganizations. If Sub-LLC transfers its real property to parent LLC, the proportional interest exclusion in Section 62(a)(2) applies.⁷

3. The ability of the member/owner of a single-member LLC to report its income and losses on the owner's tax return does not affect LEOP's ability to track changes in control and ownership.

Section 18633.5(i) requires single-member LLCs to file the LLC tax return (FTB Form 568) with FTB each year, even though the entity is disregarded and the LLC's income and losses are reported on the member/owner's individual return. FTB processes the Form 568 in order to assess and bill the \$800 annual franchise tax imposed on all LLCs and the LLC gross receipts fee. In addition, FTB's pass-thru-entity computer program tracks the interests and activities reported on both the Form 568 and the individual's tax return in order to find any discrepancies or inconsistencies.

The LLC return, Form 568, contains the following property tax question in compliance Section 64(e):

"Did ownership or control of this LLC or any of its subsidiaries or affiliates change this taxable year? (Do not leave this question blank.)"

The "yes" and blank answers to this question for single-member LLCs will be transmitted to LEOP, just as for LLCs composed of two or more members. The only difference is that if LEOP wished to review these single-member LLC returns for line items indicating reported real property ownership (i.e., mortgage payments, depreciation on buildings, etc.), such information would be on the individual's tax return, and not on the Form 568 (assuming the LLC is disregarded).

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⁷ The exclusion under Section 64(b) for transfers among affiliated entities does not apply since the express language of that statute is applicable only to corporations.

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