The POCKET LAWYER®
Self-Help Series
Understanding California Limited Liability Companies (LLC)

The information in this brochure is for educational purposes only and intended to assist you in preparing your own Limited Liability Company (LLC). It is NOT legal advice or a substitute for the professional advice of a licensed attorney.

What are the main types of business organizations?
The main types of business organizations are the sole proprietor, general and limited partnerships, corporations and Limited Liability Companies (LLC).

What is a Limited Liability Company?
A Limited Liability Company allows you to enjoy the flexibility of a partnership and the legal protection of a corporation. Because of its dual qualities of corporation protection and partnership tax treatment, the LLC could replace general partnerships, limited partnerships and S corporations as the future entity of choice.

What are the basics?
An LLC files with the Secretary of State and, once approved, becomes legally registered in California. It must have at least two “members” who may be US or foreign individuals or entities, such as partnerships, trusts, corporations, estates or other LLCs. Professionals (lawyers, accountants and doctors), however, are prohibited from registering as an LLC.

The LLC uses an operating agreement, similar to a partnership agreement, to control business, financial and tax provisions. The operating agreement may be oral, although it should be in writing and signed by all the LLC’s members. It is not filed with the Secretary of State. Management of an LLC may be vested either in the members or in certain designated “managers.” Managers do not have to be members of the LLC, and even corporations may serve as managers. Through its provisions, the operating agreement determines whether the LLC is taxed as a partnership or corporation.

There is an annual minimum franchise tax of $800 payable to the Franchise Tax Board, plus an additional tax if the LLC’s total annual income exceeds $250,000.

What are the advantages?
Members of an LLC are shielded from personal liability to the same extent as corporate shareholders. In general, the LLC will be treated as a partnership for tax purposes; it will be a flow-through entity in which income and losses are reported directly by its members. Unlike an S corporation, special allocations of income, expenses, deductions and losses can be made among its members, and an individual member’s losses are not limited by the member’s investment in the LLC. Unlike a partnership, management can be vested in nonmembers. Unlike a limited partnership, members may be actively involved in the LLC’s management, without risk of personal liability, as can occur to a limited partner.

An LLC is an ideal substitute for an S corporation when foreign shareholders, corporations or trusts are desired as shareholders. The LLC provides estate planning opportunities since trusts and estates are eligible shareholders. Also, the LLC could eventually eliminate both general and limited partnerships as business entities since it offers the same tax treatment and management opportunities, yet with the added advantage of limited liability to all its members. LLCs might also pay a substantially lower California income tax than an S corporation.

What are the disadvantages?
As a new entity, an LLC offers little legal precedent. Also, congress has not passed any tax legislation establishing the LLC as a partnership for tax purposes. Thus far, the IRS has ruled that the LLC will qualify as a

partnership for tax purposes, but there is nothing in the Internal Revenue Code that permits such treatment. In cases where there is a choice between using an S corporation or LLC, the former should be used, as it is an established business and tax entity

What are some of the tax implications of converting an existing business to an LLC?
Usually converting a limited partnership or a general partnership is considered a non-taxable event.
On the other hand, converting a C or S corporation to an LLC is considered by the IRS a taxable event at both the corporate and shareholder level.