California Franchise Tax Board August 21, 1992
FTB Notice No. 92-5

Subject: Classification of Organizations Limited Liability Companies

Significant public interest has been expressed concerning the tax classification to be accorded by the Franchise Tax Board to entities which have formed as limited companies under the laws of other states and which are doing business in California. This notice sets forth the criteria to be used to evaluate whether such entities will be classified for California income/franchise tax purposes as partnerships or corporations.

BACKGROUND

Limited liability companies are unique statutory business entities which combine the corporate characteristic of limited liability for all investors with the possibility of pass through attributes of partnerships. These entities were initially authorized under Wyoming law. As to those limited liability companies formed under Wyoming law, they have been classified as partnerships for tax purposes by the Internal Revenue Service (IRS). (Rev. Rul. 88-76, 1988-2 C.B. 360.) As a result of the Federal action, many state legislatures have addressed, and many others are asked to address, the status of these entities. A total of fifteen (15) states currently recognize limited liability companies as distinct business entities. In private letter rulings, the IRS has classified individual entities formed under the laws of several of these additional states as partnerships for tax purposes. California legislation is being proposed, but as yet has not been presented to the Legislature for consideration.

CLASSIFICATION CRITERIA

In Revenue Ruling 88-76, 1988-2 C.B. 360, the IRS held that a limited liability company formed under Wyoming statutory authority would be classified as a partnership for federal tax purposes. This ruling was based on the provisions of Internal Revenue Code section 7701, and applicable regulations, along with U.S. Supreme Court authority and Tax Court decisions interpreting those regulations. (See Morrissey v. Commissioner (1935) U.S. 344; Larson v. Commissioner, 66 T.C. 169 (1976), acq., 1979-1 C.B. 1.)

California has conformed, in substance, to the underlying federal authority cited above in Revenue and Taxation Code section 23038 and Regulation section 23038(b). Further, the Appeal of Tai Yuen Co., et al., Cal. St. Bd. of Equal., December 13, 1961, followed the Morrissey analysis in determining that, under California law, a foreign organized business relationship would be taxed in California as a partnership because is lacked adequate corporate attributes. In so holding, the Board referred to federal authorities and law in supporting its conclusion. Therefore, while California does have regulations of its own,

and thus federal regulations may not in themselves, be authoritative, the Board of Equalization has construed the California law and regulations to be consistent with federal law in this specific area of corporate versus partnership entity classifications.

Accordingly, for California purposes, the legal determination of the tax classification of a limited liability company doing business in California, or deriving income from California sources, will be made consistent with the administrative determinations of the IRS under Treasury Regulation section 301.7701-2 until such time as either federal or California legislation or regulations specifically address this issue.

APPLICATION

Since California does not currently have a limited liability company statutory authorization, the conclusions expressed in this notice apply only to entities which are duly organized under the laws of another state as a limited liability company and which either derive income from California sources or do business in California, and to their owners.

1. If a limited liability company is classified as a partnership under the foregoing criteria, it will be so classified for California tax purposes. Advance ruling requests on this classification issue must include a copy of the federal ruling request and ruling. (See, FTB Notice 89-277, May 10, 1989.)

2. All limited liability companies classified as partnerships for California tax purposes are required to file a partnership return pursuant to Revenue and Taxation Code sections 17851 and 17932.

3. To the extent a limited liability company is doing business in California, or is otherwise generating California source income, both resident and nonresident owners ("members") must file California tax returns, and are taxable on their share of California source income in the same manner as partners of a partnership doing business in California or otherwise deriving income from California sources. (See, as to individual members, Revenue and Taxation Code sections 18401, 17951, and applicable regulations, and 17851 and, as to corporate members, Revenue and Taxation Code section 25401 and Title 18, California Code of Regulations section 25137.1.

4. A limited liability company, which is not classified as a partnership under the foregoing criteria, is classified as a corporation for tax purposes and is required to file a corporate franchise/income tax return in compliance with all applicable Bank and Corporation Tax Law provisions.

DRAFTING INFORMATION

The principal author of this notice is Douglas Bramhall, Senior Tax Counsel of the Franchise Tax Board Legal Division. For further information regarding this notice, contact Mr. Bramhall at the Franchise Tax Board Legal Division, P.O. Box 1468, Sacramento, CA 95812-1468.