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What are the Differences between S Corporations and Limited Liability Companies?

In California there are various ways someone chooses to conduct business. To assist a new business owner in deciding which form of ownership will best meet their needs, get FTB 1123, Franchise Tax Board Guide to: Forms of Ownership, as an overview with filing guidelines.

The question we hear most often is "What are the differences between S corporations and Limited Liability Companies (LLCs)?"

The first thing to remember is an LLC is a legal business entity formed under state law. Generally to form an S corporation you must first create a corporation under state law. Then you must make a timely federal tax election to be an S corporation under Internal Revenue Code (IRC) Section 1362(a)(1). This S corporation election is made by filing the federal Form 2553, *Election by a Small Business Corporation*, with the Internal Revenue Service (IRS). However, even a taxpayer whose default classification is a partnership or a disregarded entity may seek to be classified as an S corporation, provided the entity meets all other requirements to qualify as a small business corporation under IRC Section 1361(b)[1].

The S corporation election affects the taxation of the business; however, it does not change the business's legal form[2] (i.e., corporation, LLC, partnership or sole proprietorship), so the underlying structure and the legal requirements of the business entity do not change. For example, corporations are required under California Corporation Code to have annual meetings, and maintain corporate minutes, LLCs are not. Corporations required to file a Statement of Information with the California Secretary of State (SOS) every year, while LLCs are required to file the Statement of Information biannually (every two years) with SOS. An S corporation election will not change these requirements.

A taxpayer who has a valid federal S corporation election must file in California as an S corporation using our Form 100S, California S Corporation Franchise or Income Tax Return.[3]

In California, an S corporation election can have a major effect on a business entity. To help assist you, we put together the following chart showing some of California differences between an S corporation and an LLC:

[1] For more details on the eligibility tests get IRS Instructions for Form 2553, *Election by a Small Business Corporation.*
[2] To change (convert) a business's legal form proper documents would need to be filed with the Secretary of State's office.
[3] Revenue and Taxation Code (R&TC) Sections 23801 and 18601

	LLC	S Corporation
Tax forms	568	100S
Business entity tax and fee	Yes Annual tax $800 (due on the 15th day of the fourth month from the start of the tax year) LLC fee of: $0, $900, $2,500, $6,000, or $11,790 based on California sourced total income plus cost of goods sold (California sourced gross receipts)	Yes Business and California non-business Income is taxed at 1.5% or minimum tax $800 whichever is more In addition, there is a Q sub tax of $800
Estimated fee or tax form	FTB 3536, Estimated Fee for LLCs Estimated LLC fee is due and payable on 15th day of the sixth month after the beginning of the tax year. Any additional fee amount is payable by the original due date of the LLC return.	Form 100-ES, Corporation Estimate Tax Estimated tax due on the 15th day of fourth, sixth, ninth and 12th month.
Tax return date due	Annual tax due15th day of 4th month of its taxable year	Income or franchise tax due 15th day of 3rd month after close of its tax year (March 15 tax return due date)
Extension form	FTB 3522, LLC Tax Voucher	FTB 3539, Payment Voucher for Automatic Extension for Corporations or Exempt Organizations, or FTB 3586, Payment Voucher for Corporations and Exempt Organizations (e-filed) Returns
First year annual tax /minimum franchise tax exception	No	Yes
Business entity estimated payments	Yes	Yes
Estimated due dates	Estimated LLC fee June 15 (15th day of 6th month)	April 15 – 30% (minimum $800) June 15 – 40% September 15 – 0% (total paid should be 70%)

		December 15 – 30%
Form to report distributive share of income	Schedule K-1 (568), Member's Share of Income, Deductions, Credits, etc.	Schedule K-1 (100S), Shareholder's Share of Income, Deductions, Credits, etc.

Note: There may be tax and legal consequences in electing to be treated as an S corporation. Taxpayers may wish to seek further advice from an expert before making an election.

For more information on key features and filing guidelines of various forms of business, get FTB 1123 or our audio presentation Small Business Video Presentation at ftb.ca.gov.

Head of Household Audit Questionnaires Coming in July

The 2012 head of household (HOH) season is just around the corner. In mid-July, we begin mailing the HOH audit questionnaires. This year, we expect to mail approximately 100,000 HOH Audit Letters for the 2012 tax year.

HOH audit staff review the completed questionnaires to determine if taxpayers qualify for the HOH filing status. If the audit letter questionnaire is incomplete or provides conflicting information, the taxpayer is contacted to resolve the issue. Once we confirm the HOH filing status, we mail an acceptance letter to the taxpayer. Acceptance letters only apply to the specific tax year examined and will not qualify the taxpayer for other tax years.

Taxpayers who fail to respond to the questionnaire or whose responses indicate they do not qualify for HOH can expect a Notice of Proposed Assessment that disallows their HOH filing status. If you have clients who receive an audit letter, advise them to respond by the letter's due date to avoid the failure to furnish information penalty.

Taxpayers who e-filed and claim the HOH filing status, have the option of electronically completing and including the HOH questionnaire (FTB 4803E) with their e-filed return. We will not mail an HOH Audit Letter to taxpayers who submitted this information electronically. They may, however, still receive a follow-up letter if they provided incomplete or conflicting information.

Taxpayers who receive a 2012 HOH Audit Letter can complete the questionnaire in any of the following ways:

- Go to ftb.ca.gov and search for **hoh web response**. They will need their social security number and the FTB ID shown at the top of the questionnaire letter. Using this method of responding to the HOH Audit Letter will expedite the processing of the questionnaire. Encourage your clients to use this method.
- Fax the completed questionnaire, and any supporting information to 866.223.8195.
- Mail it with the enclosed preaddressed envelope.

For more information about the HOH filing status, go to ftb.ca.gov and search HOH Response.

Free Webinar
Self-Help: Using Our Website to Help You

Join us as our presenters show you the quick and easy online process to:

- Apply for an individual installment agreement.
- Respond to a Head of Household questionnaire.
- Respond to individual filing enforcement notices.

Date and Time: Tuesday, June 12, 2013, 10 a.m.; 60 minutes

Registration: **Register Now** to reserve your space. For more information, go to ftb.ca.gov and search for **webinar**.

Free Webinar

Individuals: 10 Reasons Why We Issue RINs and How to Prevent Them

During this webinar, we go over the top 10 reasons we issue individual Return Information Notices (RINs). We will provide you with quick and easy tips on how to prevent them.

Date and Time: Tuesday, June 25, 2013, 10 a.m.; 30 minutes

Registration: **Register Now** to reserve your space. For more information, go to ftb.ca.gov and search for **webinar**.

FTB en Español – Automated Installment Agreement Information and Products Available in Spanish

If a taxpayer owes less than $25,000 in state taxes and has the ability to pay their balance in full within 60 months, they may qualify for an installment agreement. Help is now available in Spanish.

How can they request an installment agreement?

- By mail – complete and mail Form 3567, Installment Agreement Request.
- By telephone – use our Automated Telephone Assistance available 24 hours a day at 800.689.4776.
    - Press 2 – Spanish
    - Press 3 – Information on installment agreements
    - Press 1 – Apply for an installment agreement

For more information, to go ftb.ca.gov and search acuerdo de pago a plazos.

Ask the Advocate

Revenue Estimating Methods

During our Taxpayer Bill of Rights Hearing in December, the tax practitioner community asked for an overview to our revenue estimating methods. Our Economic and Statistical Research Bureau created a webpage, Franchise Tax Board Revenue Estimating Methods, on how we construct revenue estimates, use our estimation tools, and model taxpayer responses to change in tax law. We believe that providing objective estimates of the revenue impacts of tax policy proposals enables policymakers to make sound tax policy decisions.

Steve Sims, EA
Taxpayers' Rights Advocate

Follow me on Twitter at twitter.com/FTBAdvocate.

Event Calendar

As part of our education and outreach to our tax professional community, we participate in many different presentations and fairs. We now provide a combined-calendar to show the events we are attending, as well as other events happening with us, such as interested party and board meetings.

Inside FTB

Federal Income Tax Changes Summary for 2012

We prepared our 2012 Summary of Federal Income Tax Changes that we provide annually to the Legislature. Our 2012 summary explains new federal laws, along with the effective dates, and the corresponding California law, if any. It includes an explanation of any changes made in response to the new federal law, and the impact on California revenue if California conforms to the federal changes.

The summary also contains citations to the section numbers of federal public laws, IRC, and how the federal changes affect R&TC.

Criminal Corner

Couple Scammed Hundreds of Elderly Out of Nearly $2 Million

San Diego County District Attorney, Bonnie M. Dumanis, charged a fake insurance agent and his wife with 11 felony counts including burglary, grand theft, theft from an elder, tax evasion, and other charges for their roles in bilking $1.9 million from hundreds of San Diego County senior citizens in a scam in which the couple sold phony “in-home service agreements.”

Michael Woodward, 50, and his wife, Melissa Woodward, 47, were arrested at their home in Las Vegas, Nevada on April 10 and extradited to San Diego to face charges. They face up to 16 years in local prison if convicted of the charges.

For nearly a decade, Michael and Melissa Woodward swindled 238 San Diego seniors out of more than $1.9 million in premiums. They would target senior citizens at their homes telling them that for a prepaid annual fee, the victim could get an unlimited

amount of non-medical services such as cooking, cleaning, bathing, toileting, dressing, laundry, and shopping. To receive services, he told the victims, they should call him and provide a doctor's note.

The case was investigated by the California Department of Insurance (CDI) and then referred to the District Attorney's Insurance Fraud Division for further investigation and prosecution. Franchise Tax Board special agents also assisted in the investigation. Because Woodward and his wife lived in Las Vegas, CDI Investigators contacted the Nevada Attorney General's Office for assistance. Investigators from the Insurance Fraud Unit of the Nevada Attorney General's Office provided tremendous help, acquiring a search warrant for Woodward's residence, making entry and then allowing CDI investigators to search it. As the CDI searched the home, investigators from the Nevada Attorney General's Office took the Woodwards into custody and transported them to jail.

In reality, Woodward's plan was a sham. He and his wife were the only employees of the company and were not able to provide the in-home services he offered. The most he did includes paying a third party to provide the requested services or reimbursing seniors for the expense of acquiring services on their own.

Inexpensive claims, such as requests for housecleaning, were often paid, but when victims made claims that were more expensive, Woodward would not return phone calls and would reject the claim. He also routinely returned to victims' homes to collect additional premiums, well beyond the original cost he quoted for the plan.

The Woodward's fraudulent activities in San Diego follow similar actions in other states including Washington, Oregon, Minnesota, and Texas. In all, he bilked victims out nearly $6 million across the nation. When dealing with senior citizens, he often used false names, such as Mike Woods or Mike Smith, making it difficult to research his past.

Big Business

Tiered Limited Liability Companies (LLCs owning LLCs) – Fee or No Fee?

When it comes to tiered LLCs, each entity will have an annual tax. But, when it comes time to determine whether or not the LLC will have to pay a fee, the process is not always clear cut.

California law[4] imposes an annual fee on every LLC that has "Total California Income" of $250,000 or more. "Total Income" for this purpose means gross income, plus the cost of goods sold, paid, or incurred in connection with the trade or business of the taxpayer attributable to California; and specifically excludes all allocations, distributions, or gains from another LLC that was already subject to the LLC fee.

So when you are looking to determine how the LLC's "Total California Income" is, don't include gross receipts received from another LLC that were included in that LLC's calculation of the fee. If the income has already been reported by another LLC, do not enter the amounts on the Schedule IW (LLC Income Worksheet).

The Schedule IW is now Side 6 of the California Form 568 and it must always be included with the Form 568, even if the LLC does not have income derived from or attributable to California. If the LLC is wholly within California, the total income amount is assigned to California and is entered beginning with line 1a. If a single member LLC (SMLLC) does not meet the $3 million criteria[5] for filing Schedule B (Form 568) and Schedule K (Form 568), the SMLLC is still required to complete Schedule IW. Disregarded entities that do not meet the filing requirements to complete Schedule B or Schedule K should prepare Schedule IW by entering the California amounts attributable to the disregarded entity from the member's federal Schedule B, C, E, F (Form 1040), or additional schedules associated with other activities.

For more information, get instructions on Page 13 of the 2012 Form 568, Limited Liability Company Tax Booklet, on how to complete Schedule IW.

Example 1:
LLC A has $1,200,000 of total California sourced income during 2012 taxable year. LLC B has 50 percent member interest in LLC A. LLC B has $900,000 of total California sourced income during 2012. LLC B's income includes $600,000 ($1,200,000 x 50% member interest) from LLC A ($1.2 million x 50 percent member interest). For taxable year 2012, LLC B excludes $600,000 of total income because it was already used to calculate the fee of the LLC A.
The filing requirements are:

Entity	2012 Form	Annual Tax	Total Income	LLC Fee
LLC A	568	$800	$1,200,000	$6,000
LLC B	568	$800	$300,000 ($900,000-$600,000)	$900

Example 2:
LLC 1 owns LLC 2 and LLC 3. LLC 1 has $1,400,000 of total California sourced income during the 2012 taxable year. LLC 2 has $1,000,000 and LLC 3 has $300,000 of total California sourced income during the 2012 taxable year. Since LLC 1 has 100 percent

[4] R&TC section 17942
[5] Either 1) the income or loss amount reported on Schedule B, line 1 or line 3 through line 11, is $3,000,000 or more or 2) the "Total distributive income/payment items," Schedule K, line 21a, is greater than or equal to $3,000,000 OR less than or equal to $-3,000,000.

member interest in LLC 2 and LLC 3. LLC 1 has income that includes LLC 2 and LLC 3's income totaling $1,300,000. For taxable year 2012, LLC 1 excludes $1,300,000 of total income when determining its total California sourced income for purposes of calculating its fee because this income was already used to calculate the fees of the LLC 2 and LLC 3. LLC 1 will only pay a fee if LLC 1 has total California sourced income of $250,000 or more.

The filing requirements are:

Entity	2012 Form	Annual Tax	Total Income	LLC Fee
LLC 1	568	$800	$100,000 [$1,400,000-($1,000,000+$300,000)]	$0
LLC 2	568	$800	$1,000,000	$6,000
LLC 3	568	$800	$300,000	$900