

Franchise Tax Board's Guide to:



Forms of Ownership



As a new business owner, one of the first critical questions is deciding which form of ownership will best meet your business needs. Selecting the legal structure for your business should be well thought out and discussed with a qualified professional (e.g., attorney, C.P.A., etc.) who specializes in the subject matter. In addition, as your business grows over time, you will need to determine whether the current form of ownership still fits your needs or whether a new form of ownership will achieve better results. Although there are many forms of business to choose from, listed below are the most common legal structures available for the business owner.



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Sole Proprietorship – This is the simplest and most common form of starting a new business. It has no existence apart from its owner. A sole proprietorship consists of only “one” individual; ownership by more than one person creates a partnership.

(Note: A husband and wife can be classified as a sole proprietorship. A business conducted by registered domestic partners must be classified as a partnership.)

Key Features:

- It is inexpensive to start a sole proprietorship.
- A separate bank account should be established to run the operations.
- The owner of the sole proprietorship controls all facets of the business.
- The business and the owner are one. There is no separate legal entity and thus no separate legal person.
- The sole proprietor is personally liable for all debts and actions of the company.
- The life of the business continues to exist as long as the business owner is alive. Once the owner dies, the sole proprietorship no longer exists.
- It is advisable to purchase insurance to cover the risks of running your business. Consider consulting an insurance specialist on the matter.

Filing Guidelines:

- Report your business income and expenses on federal Schedule C, *Profit or Loss from Business*. If you are required to complete federal Schedule C, then you must provide a copy of your federal return, including Schedule C. This form is included with your Form 540, *California Resident Income Tax Return*.
- The return due date is normally April 15 for calendar year taxpayers.
- The tax rate depends on the proprietor’s total taxable income.

Estimated Tax:

- A sole proprietorship will include all sources of income (e.g., wage income, investment income) when determining estimated tax payments.
- Installments are due and payable on April 15, June 15, September 15 of the taxable year and January 15 of the following taxable year.
- Individuals complete Form 540-ES, *Estimated Tax for Individuals* to report their estimated taxes.
- Generally, estimated tax payments are required if you expect to owe at least \$500 (\$250 if married/registered domestic partner filing separately) in taxes for the current year (after subtracting withholding and credits), and you expect your withholding and credits to be less than the smaller of:
 1. 90 percent of the tax on your current tax return or
 2. The tax listed on your prior year tax return including Alternative Minimum Tax. Prior year exception is eliminated if your adjusted gross income (AGI) is greater than \$1 million (\$500,000 if married/registered domestic partner filing separately.)



Partnership – A partnership involves two or more persons carrying on a business for profit. The business is not a separately taxed entity, but rather, a conduit where the profits or losses of the partnership flow through to the partners. There are two basic types of partnerships: a general partnership and limited partnerships.

A general partnership involves two or more persons who agree to create a business and to share the profits and losses. All of the partners share equal rights and responsibilities in managing the business. In addition, each general partner assumes full personal liability for the debts and obligations of the partnership.

A limited partnership involves two or more persons who agree to create a business and share in the profits and losses. A limited partnership has at least one general partner and at least one limited partner. The general partner is responsible for managing the business affairs, while the limited partner typically provides only capital to the partnership. As in a general partnership, each general partner assumes full personal liability for the debts and obligations of the partnership. The limited partner's liability is limited to their investment in the business.

In order to form in California, a limited partnership must first file a certificate of limited partnership with the California Secretary of State. A limited partnership formed in another state must register with the California Secretary of State prior to conducting business in the state.

Key Features:

- A partnership is a flexible form of business and relatively easy to set up.
- The partners will decide the structure of the organization and the distribution of profits and losses. A formal, written partnership agreement is advisable.
- A separate bank account should be established to run the operations.
- A partnership allows more than one owner, unlike a sole proprietorship.
- The cost to form a partnership is generally less expensive than forming a corporation.
- The partnership does not pay income tax. However a limited partnership must pay an annual tax of \$800. The items of income, deductions, and credits “flow down” from the partnership to the individual partners through the California Schedule K-1 (565), *Partner's Share of Income, Deductions, Credits, etc.* Each partner is responsible for paying taxes on their distributive share.
- In a general partnership, each partner is personally liable for all business debts and lawsuits.
- A partnership exists as long as the partners agree it will and as long as there are at least two partners, one of which is a general partner.

Filing Guidelines:

- Every partnership that engages in a trade or business in California or earns income from California sources must file a California Form 565, *Partnership Return of Income*. Every limited partnership that is registered with the California Secretary of State must file Form 565, even if it has no income from California sources.
- The partnership provides each partner with a Schedule K-1 that states the partner's distributive share of the partnership's items of income, deductions, and credits.
- The return due date is the 15th day of the 4th month after the close of the taxable year.
- A limited partnership must pay an annual tax of \$800.

Estimated Tax:

The partnership has no estimated tax requirements. However, partners may have to make estimated tax payments for their own reporting purposes.

The partnership may be required to withhold taxes if the partnership distributes California source taxable income to a nonresident partner. For more information about partnership withholding, see FTB 1017, *Resident and Nonresident Withholding Guidelines*.



Limited Liability Partnership (LLP) – An LLP is a form of ownership in which all the partners receive limited liability protection. However, an LLP is similar to a general partnership in that all the partners can take an active role in managing the day-to-day affairs of the business. The LLP form of ownership is limited in the State of California to persons licensed to practice in the fields of public accountancy, law, or architecture.

In order to form in California, an LLP must first register with the California Secretary of State. An LLP formed in another state must register with the California Secretary of State prior to conducting business in the state.

Key Features:

- The LLP is a flexible form of business.
- It is designed primarily for specific professional services.
- The partners will decide the structure of the organization and the distribution of profits and losses. A formal, written partnership agreement is advisable.
- An LLP does not pay income tax. However an LLP must pay an annual tax of \$800.
- The items of income, deductions, and credits “flow down” from the partnership to each partner through the Schedule K-1. Each partner is responsible for paying taxes on their distributive share.
- The LLP allows each partner to actively participate in management affairs.
- The LLP provides limited liability protection to each partner.
- An LLP remains in effect based on partners agreeing to a termination date.

Filing Guidelines:

- Every LLP that engages in a trade or business in California or earns income from California sources and every LLP that registers with the California Secretary of State is required to file California Form 565.
- The LLP provides each partner with a Schedule K-1 that states the partner's distributive share of the LLP's items of income, deductions, and credits.
- The return due date is the 15th day of the 4th month after the close of the taxable year.
- An LLP must pay an annual tax of \$800.

Estimated Tax:

The LLP has no estimated tax requirements.

The LLP may be required to withhold taxes if the partnership distributes California source taxable income to a nonresident partner. For more information about partnership withholding, see FTB I017.

Limited Liability Limited Partnership (LLLP) – An LLLP is a new modification of the limited partnership. Similar to a limited partnership, the LLLP consists of one or more general partners and one or more limited partners. The key advantage of this form of ownership is that the general partners receive limited liability on the debts and obligations of the LLLP. California law does not allow for an LLLP to be formed in California. However, an LLLP that is formed under the laws of another state must register with the California Secretary of State prior to conducting business in the state.

Key Features:

- The general partners manage the business operations of the LLLP, while the limited partners typically only maintain a financial interest.
- The LLLP is a flexible form of business.
- It is designed to offer limited liability to all partners in the partnership.
- The partners will decide the structure of the organization and the distribution of profits and losses. A formal, written partnership agreement is advisable.
- An LLLP does not pay income tax. However an LLLP must pay an annual tax of \$800. The items of income, deductions, and credits “flow down” from the partnership to each partner through the Schedule K-1. Each partner is responsible for paying taxes on their distributive share.
- An LLLP remains in existence until any agreed upon termination date.

Filing Guidelines:

- Every LLLP that engages in a trade or business in California or earns income from California sources and every LLLP that registers with the California Secretary of State is required to file California Form 565.
- The LLLP provides each partner with a Schedule K-1 that states the partner's distributive share of the partnership's (LLLP's) items of income, deductions, and credits.
- The return due date is the 15th day of the 4th month after the close of the taxable year.
- An LLLP must pay an annual tax of \$800.

Estimated Tax:

The LLLP has no estimated tax requirements.

The LLLP may be required to withhold taxes if the partnership distributes California source taxable income to a nonresident partner. For more information about partnership withholding, see FTB 1017.

Corporation – A corporation is an entity formed under state civil law that is a separate legal entity owned by shareholders. A corporation is generally taxed under Internal Revenue Code, Subtitle A, Chapter I, Subchapter C, unless it elects to be taxed under Subchapter S. Corporations taxed under Subchapter C ("C corporations"), are taxed annually on their earnings and the shareholders are taxed on these earnings when distributed as dividends. If the corporation is a service corporation by an employee-owner, see page 18 for more information regarding personal service corporations.

Key Features:

- Must register with the California Secretary of State before conducting business operations and file appropriate paperwork.
- Must create bylaws (e.g., how the corporation will operate) that cover items such as stockholder meetings, director meetings, number of officers, and their responsibilities.
- If formed as a corporation, the owners of the corporation are not liable for the losses of the businesses and creditors may only look to the corporation and the business assets for payment.
- A separate bank account and separate records are required.
- Owners have ultimate control of the corporation; but must elect directors who in turn elect officers for the company. The directors make the major decisions, while the officers make the day-to-day decisions.
- The life of the corporation is perpetual in nature.
- Ownership is easily transferred through the sale of stock, and new owners can be easily added by the issuance of additional stock. For entities that are not civil law corporations, the ownership interests are generally treated as "shares of stock" for tax purposes.
- Is more costly to set up and maintain than a sole proprietorship or partnership. Consult an attorney for guidance on setting up your corporate entity.



Filing Guidelines:

- Corporations taxable as a C corporation that organize in California, register in California, conduct business in California, or receive California source income must file California Form 100, *California Corporation Franchise or Income Tax Return*. Other entities that elect to be taxable as a C corporation must file California Form 100 if they receive California source income.
- The return due date is the 15th day of the 3rd month after the close of the taxable year.
- A C Corporation is taxed on its net income at a rate of 8.84 percent. Entities formed as corporations under civil law and LLCs that elect to be taxable as a C corporation are subject to a minimum tax of \$800.
- The minimum franchise tax (\$800) is due the first quarter of each accounting period and must be paid whether the corporation is active, inactive, operates at a loss, or files a return for a short period of less than 12 months. The minimum tax is waived on newly formed or qualified corporations filing an initial return for their first taxable year.

Estimated Tax:

- The estimated tax is payable in four installments. (See Instructions for California Form 100-ES, *Corporation Estimated Tax* for additional information and applicable rates).
- Installments are due and payable on April 15, June 15, September 15, and December 15.
- Corporations complete Form 100-ES to report their estimated taxes.
- Shareholders may have to make estimated tax payments for their own reporting purposes.



S Corporation – An S corporation is a corporation formed under state civil law or any business entity, (such as a partnership or LLC that elects to be taxable as a corporation for tax purposes), that elects under federal law to be taxed under Subchapter S. An entity that has elected to be taxable as an S corporation for federal tax purposes is also treated as an S corporation for California tax purposes. An S corporation generally offers liability protection to its owners (shareholders) and is a conduit where the profits or losses of the S corporation flow through to the shareholder(s)/partners/member(s). Liability of the owners for debts and obligations of the business depends on what type of entity the S corporation is under state civil law, e.g. corporation, partnership, or LLC.

Key Features:

- An entity must elect to be treated as an S corporation and is limited by the types of owners which may not exceed 100 shareholders.
- An S corporation does not pay federal income tax.
- Under California law, the S corporation is subject to a 1.5 percent tax on its net income and is a conduit similar to a partnership.
- The items of income, deductions, and credits “flow down” from the S corporation to each shareholder through the Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.* Each shareholder is responsible for paying taxes on their pro rata share of the S corporation's items of income, deductions, and credits.
- If the entity is formed as a corporation under state law, the shareholders of the corporation are not liable for the losses of the business and creditors may only look to the corporation and their business assets for payment.
- A separate bank account and separate records are required with this form of entity.
- The management structure of the S corporation will depend upon what type of entity it is under state civil law, e.g. corporation, partnership, or LLC.
- The life of an S corporation depends on what type of entity it is for state civil law purposes.

Filing Guidelines:

- An S corporation that organizes in California, registers in California, conducts business in California, or receives California source income must file California Form 100S, *California S Corporation Franchise or Income Tax Return*.
- The S corporation must provide each shareholder with a Schedule K-1 that states the shareholder's pro rata share of the S corporation's items of income, deductions, and credits.
- The return due date is the 15th day of the 3rd month after the close of the taxable year.
- An S corporation is taxed on its net income at a rate of 1.5 percent for California purposes. S corporations are not subject to income tax for federal income tax purposes.
- S corporations that are corporations or LLCs under civil law corporations must pay the annual \$800 minimum franchise tax.

Estimated Tax:

- The estimated tax is payable in four installments. (See California Form 100-ES instructions for additional information and applicable rates)
- Installments are due and payable on April 15, June 15, September 15, and December 15.
- Corporations complete Form 100-ES to report their estimated taxes.
- Shareholders may have to make estimated tax payments for their own reporting purposes.



Limited Liability Company (LLC) – An LLC is a newer form of business entity. It has advantages over corporations and partnership. The LLC's main advantage over a partnership is that, like the owners (shareholders) of a civil law corporation, the liability of the owners (members) of an LLC for debts and obligations of the LLC is limited to their financial investment. However, like a general partnership, members of an LLC have the right to participate in management of the LLC, unless the LLC's articles of organization and operating agreement provide that the LLC is to be managed by managers.

For California income tax purposes, an LLC with more than one member will be classified as a partnership and an LLC with a single individual member will be classified as a sole proprietorship, unless the LLC chooses to be classified as a corporation for income tax purposes. To be taxed as a corporation, the LLC files an election on a Form 8832, *Entity Classification Election* with the Internal Revenue Service. For income tax purposes, California treats the LLC, and its owners, in the same manner the LLC is treated for federal tax purposes.

Key Features:

- An LLC may have one or more owners, and may have different classes of owners. In addition, an LLC may be owned by any combination of individuals or business entities. An LLC that is taxable as a partnership can achieve both conduit tax treatment and limited liability protection under civil law, similar to an entity taxable as an S corporation. However, an LLC taxable as a partnership does not have the ownership restrictions that apply to entities taxable as S corporations.
- If the LLC has a single member, it will be disregarded as separate from its owner, and will be treated as a sole proprietorship or a division of its owner, unless it elects to be taxable as a corporation.
- In general, all the owners (members) are shielded from individual liability for debts and obligations of the LLC.
- An LLC is formed by filing “articles of organization” with the California Secretary of State prior to conducting business.
- Forming an LLC is simpler and faster than forming and maintaining a civil law corporation.
- LLCs do not issue stock, and are not required to hold annual meetings or keep written minutes, which a corporation must do in order to preserve the liability shield for its owners.
- Either before or after filing its articles of organization, the LLC members must enter into a verbal or written operating agreement. A formal, written agreement is advisable.
- An LLC is typically managed by all its members, unless the members agree to have a manager handle the LLC's business affairs.

- Generally, members of an LLC that is taxed as a partnership may agree to share the profits and losses in any manner. Members of an LLC that is classified as a corporation, receive profits and losses in the same manner as shareholders of a corporation legally organized as such.
- An LLC's life is perpetual in nature. However, the members may agree, to a date or event of termination.

Filing Guidelines:

- All LLCs, which are classified as a corporation, and organize in California, register in California, conduct business in California, or receive California source income, must file California Form 100. The California Form 100 must be filed by the 15th day of the 3rd month after the close of the LLC's taxable year.
- The LLC will be taxed at the corporate tax rate of 8.84 percent and will be subject to a minimum tax of \$800.
- All LLCs, which are classified as partnerships or disregarded entities, and organize in California, register in California, or conduct business in California must file California Form 568, *Limited Liability Company Return of Income*. Form 568 must be filed by the 15th day of the 4th month after the close of the LLC's taxable year.
- An LLC required to file Form 568 pays an annual tax of \$800, and may be subject to an LLC fee based on total income from all sources derived from or attributable to the State of California. The annual tax is due by the 15th day of the 4th month of the taxable year, and is paid using FTB 3522, *Limited Liability Company Tax Voucher*. The estimated LLC fee is due by the 15th day of the 6th month.
- In addition, an LLC filing Form 568, which has members who are not residents of California must file FTB 3832, *Limited Liability Company Nonresident Members' Consent* with Form 568. FTB 3832 is signed by the nonresident individuals and foreign entity members to show their consent to California's jurisdiction to tax their distributive share of income attributable to California sources. The LLC must pay the tax for every nonresident member that did not sign a FTB 3832.



Estimated Tax:

If the limited liability company is classified as a corporation and files California Form 100, the following estimated tax guidelines apply:

- The estimated tax is payable in four installments. (See California Form 100-ES instructions for additional information and applicable rates)
- Installments are due and payable on April 15, June 15, September 15, and December 15.
- Corporations complete Form 100-ES to report their estimated taxes.
- Additionally, members may have to make estimated tax payments for their own reporting purposes.

If the limited liability company is classified as a partnership or disregarded entity and files California Form 568, the following estimated tax guidelines apply:

- Estimated LLC fee is due by the 15th day of the 6th month.
- Members may have to make estimated tax payments for their own reporting purposes.

The LLC treated as a partnership may be required to withhold taxes if the partnership distributes California source taxable income to a nonresident member. For more information about partnership withholding, see FTB 1017.

Series Limited Liability Company (Series LLC) – A series LLC is a new form of LLC that may be formed under the laws of some states. A series LLC is a master LLC whose organizing document provides for separate sub-units (series), which operate as independent LLCs. California law does not allow for a series LLC to be formed in California. However, a series LLC that is formed under the laws of another state may register with the California Secretary of State and transact business in California.

Key Features:

- Each unit has its own owners (members) and may be managed separately from the master LLC and other units.
- Each unit must maintain separate books and records.
- As with a regularly formed LLC, the owners (members) of each unit are not financially responsible for the unit's debts and obligations.
- A unit may conduct part of the business of the master LLC, or may conduct a wholly different business.
- Each unit has its own assets and liabilities. The members of each unit are treated under the laws of the state where the master LLC is formed as owning an interest in only that unit, and have no rights as members of one unit in the assets or income of any other unit.
- Each unit is liable only for its own debts and obligations. In general, creditors of one unit may only make claims against the assets of that unit.

Filing Guidelines:

Currently, the Internal Revenue Service has not stated whether a unit within a master LLC is generally a separate entity from the master LLC and other units for tax purposes. However, it has treated units of a master (Series) LLC as separate tax entities in one private letter ruling. The Franchise Tax Board has taken the position that if each unit has the features listed above under the laws of the state where the series LLC was formed, then each unit will be treated as a separate entity for filing and tax purposes. In that case, the same filing guidelines and estimated taxes that apply to a regular LLC will apply to each unit of a series LLC.

Personal Service Corporation – A personal service corporation is defined as a corporation whose principal business activity is the performance of personal services and such services are performed by employee-owners. Individuals who perform services in fields such as health, law, engineering, architecture, performing arts, and accounting typically use this classification.

A corporation is a personal service corporation if it meets all of the following requirements:

1. Its principal activity during the testing period is performing personal services. Personal services include any activity performed in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts. Generally, the testing period for any tax year is the prior tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:

- The last day of its tax year, or
- The last day of the calendar year in which its tax year begins.

2. Its employee-owners (detailed below) substantially perform the personal services. This requirement is met if more than 20 percent of the corporation's compensation cost for its activities of performing personal services during the testing period is for personal services performed by employee-owners.

3. Its employee-owners own more than 10 percent of the fair market value of its outstanding stock on the last day of the testing period.

Employee-owners – A person is an employee-owner of a personal service corporation if both of the following apply:

- The individual is an employee of the corporation or performs personal services for, or on behalf of, the corporation (even if the individual is an independent contractor for other purposes) on any day of the testing period.
- The individual owns any stock in the corporation at any time during the testing period.

Filing Guidelines:

- A personal service corporation that organizes in California, registers in California, conducts business in California, or receives California source income must file either a California Form 100 or California Form 100S, if it elected to be taxed as an S Corporation.
- The return due date is the 15th day of the 3rd month after the close of the taxable year.
- A personal service corporation pays taxes on its net income at an applicable rate for either a corporation or S corporation with a minimum tax of \$800.

Estimated Tax:

- The estimated tax is payable in four installments. (See California Form 100-ES instructions for additional information and applicable rates.)
- Installments are due and payable on April 15, June 15, September 15, and December 15.
- Corporations complete Form 100-ES to report their estimated taxes.



For Additional Information:

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For General Information:

taxes.ca.gov