

# CALIFORNIA LIMITED LIABILITY COMPANY REVIEW

## LLC CONVERSIONS

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A California general or limited partnership may wish to convert into a California limited liability company (LLC) to take advantage of limited liability protection for all of its members. This is particularly relevant for general partnerships because each partner generally is jointly and severally liable for the liabilities of the partnership merely by being a general partner. However, even with a limited partnership, at least one partner, the general partner, has to be liable, and limited partners can be held liable if they participate in a wrong fashion in the affairs of the limited partnership.

The first issue to address is how to convert. It seems that the partnership could convert into an LLC in at least five ways: (i) contribute assets and liquidate, (ii) liquidate and then contribute the assets, (iii) contribute all of the partnership interests, (iv) merge the partnership into the LLC under state corporate law, or (v) statutorily convert the partnership to an LLC. California enacted legislation to provide for statutory conversions effective January 1, 2000.

In 1995, the IRS issued Revenue Ruling 95-37, which rules that a conversion of a

limited partnership to an LLC taxed as a partnership does not terminate the partnership or the partnership year with respect to any of the partners. The partnership continues on uninterrupted using the TIN of the limited partnership. The ruling states that if liabilities shift among the partners, the conversion could cause a taxable event.

In California, a statutory conversion of a partnership owning California real property will in most cases be the desired form of conversion. A statutory conversion generally has the effect of causing the LLC to be the same entity as the partnership. Accordingly, the partnership does not transfer the real property which would require claiming and proving an exclusion from property tax reassessment of the real property.

However, a statutory conversion does not cause the LLC to be treated as the same entity as the partnership for California income taxation. That means both a converting limited partnership and the converted LLC would pay the \$800 annual minimum tax and the LLC would pay an LLC fee on the income derived while an LLC. Although it appears that only \$800 is at stake, California requires both the partnership and the LLC to file a short

period tax return for the year of the conversion (if the conversion is not at year end). Instructions to FTB Forms 565 and 568 California currently require FULL tax returns from each, including K-1s. Therefore, contrary to federal law, a partner should receive 2 California K-1s for the year of a conversion not done at year-end.

I am currently working to get the Franchise Tax Board to change its position and not require a full tax return or K-1s from the entity that converts. It seems that filing a simple one page return could potentially save both California and the converted entity from incurring substantial costs in auditing, processing, or preparing a tax return that yields no additional revenue and creates confusion among partners receiving multiple California K-1s different from the federal K-1.

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