California Court of Appeal Affirms Passive LLC Interest Alone Is Not "Doing Business"

Overview

On January 12, 2017, the California Court of Appeal affirmed the trial court's decision in *Swart Enterprises, Inc. v. California Franchise Tax Board*, concluding that an out-of-state corporation was not "doing business" in California within the meaning of Cal. Rev. & Tax. Code ("CRTC") Section 23101, when the corporation's only connection to California was its passive ownership of a 0.2 percent membership interest in a California-based manager-managed limited liability company.[1] The Court of Appeal's decision is not yet final and the California Franchise Tax Board ("FTB") still has time to file a petition for review with the California Supreme Court.[2] This Tax Alert summarizes the Court of Appeal's decision in *Swart* and provides some taxpayer considerations.

Summary of facts in *Swart*

Swart Enterprises, Inc. ("Swart"), was an out-of-state corporation that had no physical presence in California, did not sell or market products or services to California, and was not registered to transact business with the California Secretary of State.[3] Swart's sole connection to California was its ownership of a 0.2 percent membership interest in a limited liability company ("LLC") that had been organized under California law. The LLC was manager-managed and was formed for the purpose of acquiring, holding, leasing, and disposing of capital equipment. The LLC's articles of organization and operating agreement granted the manager "full, exclusive, and complete authority in the management and control of the business of the LLC."[4] Swart was not involved with the LLC's operations or management and was prohibited under the operating agreement from participating in the management and control of the LLC.[5]

For taxable year 2010, the FTB asserted that Swart was "doing business" in California and required to file a corporate franchise tax return and pay the $800 minimum franchise tax. This assertion was based solely on the FTB's determination that Swart owned an ownership interest in a LLC that had elected to be taxed as a partnership and that the LLC was "doing business" in California.[6]

California Court of Appeal's decision

The Court of Appeal held that Swart was not "doing business" in California within the meaning of CRTC Section 23101. First, the Court considered the plain language of Section 23101, which defines "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."[7] The Court concluded that Swart was not "actively" engaging in any transaction because it "merely passively held onto its investment in the year the franchise tax was imposed."[8]

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[1] *Swart Enterprises., Inc. v. Cal. Franchise Tax Bd.,* Case No. F070922, available here. The trial court's decision is discussed in more detail in our Multistate Tax Alert, dated December 19, 2014, available here.
[2] Generally, the Court of Appeal's decision becomes final thirty days after filing. Cal. Rules of Ct., R. 8.264(b). The FTB has ten days after the Court of Appeal's decision becomes final to file a petition for review with the California Supreme Court. Cal. Rules of Ct., R. 8.500(e).
[3] *Id*.
[4] *Swart,* No. F070922 at p.3.
[5] *Id.*
[6] *Id.*
[7] *Swart,* No. F070922 at p.5. For taxable years beginning January 1, 2011, "doing business" was expanded to also mean if the taxpayer is organized or commercially domiciled in California, or a taxpayer's California sales, property, or payroll exceeds the applicable thresholds under CRTC Section 23101(b). Cal. Rev. & Tax Code § 23101(b); *Swart,* No. F070922, n.1. Because the taxable year at issue in *Swart* ends on June 30, 2010, this new "doing business" standard did not apply in the case and thus, the Court of Appeal did not discuss its application therein.
[8] *Swart,* No. F070922 at p.6.

The Court also addressed the FTB's contention that members of an LLC that has elected to be taxed as a partnership for federal income tax purposes are rendered general partners of the LLC for purposes of California tax. Although the FTB argued that, under Internal Revenue Code Section 702,[9] "doing business" could be imputed to Swart by way of its interest in the LLC whether or not the LLC was member-managed or manager-managed,[10] the Court of Appeal found the FTB's arguments flawed. Notably, the Court of Appeal reasoned that, if an LLC's tax election causes the members of the LLC to be "partners" for all taxation purposes, no meaningful distinction can be drawn between the limited partnership interest at issue in the *Appeal of Amman & Schmid* decision of the California Board of Equalization,[11] and Swart's membership interest. In *Amman & Schmid,* the California Board of Equalization held that a limited partner was not "doing business" merely by virtue of its ownership interest in a limited partnership.[12] In the Court of Appeal's opinion, the logic of *Amman & Schmid* should also apply to LLCs taxed as partnerships.[13]

In the current matter, the Court agreed with Swart's argument that the rights and obligations it had as a result of owning a 0.2 percent interest in a manager-managed LLC were similar to those of a limited, not general, partner.[14] Under the LLC's agreements, Swart had no interest in any of the LLC's property, was not personally liable for the LLC's obligations, had no right to act on behalf of or to bind the LLC, and no ability to participate in the management and control of the LLC.[15] Based on the above,[16] the Court of Appeal concluded that, because the business activities of a partnership cannot be attributed to limited partners, Swart cannot be deemed to be "doing business" solely by virtue of its ownership interest in the LLC.[17]

Considerations

Although the Court of Appeal's decision in *Swart* is not yet final and the FTB still has time to file a petition for review with the California Supreme Court, taxpayers may want to consider the impact of this decision when determining whether they are "doing business" in California and are subject to the $800 minimum tax. Contrary to the FTB's position over the years,[18] the *Swart* decision clarifies that *Amman & Schmid* does apply to non-managing members who passively hold an interest in an LLC.

While the Court in *Swart* held that passive ownership of a non-managing membership interest in an LLC does not constitute "doing business" under CRTC Section 23101(a), the *Swart* decision does not impact general partners and managing members of LLCs. In addition, non-managing members of an LLC may still have a California tax filing requirement to report their distributive share of California source income from the LLC.

One final word of caution. If a non-managing member's distributive share of the LLC's sales, property, or payroll exceeds the applicable threshold under CRTC Section 23101**(b),** that member is still considered to be "doing business" in California and thus, must file a California tax return and pay the California Franchise Tax and applicable

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[9] Internal Revenue Code Section 702 provides that the character of an item of income, gain, loss, deduction, or credit to be included in a partner's distributive share is determined at the partnership level "as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." I.R.C. § 702(b); *see Swart,* No. F070922 at p.9.

[10] *Swart,* No. F070922 at p.7-10, 15.

[11] *Appeal of Amman & Schmid Finanz AG, et al.,* 96-SBE-008 (Cal. St. Bd. Of Equal. Apr. 11, 1996).

[12] *Amman & Schmid,* 96-SBE-008*; see also Swart,* No. F070922 at p.10. The Court of Appeal also noted that no cited legal authorities support the FTB's argument that an LLC's taxation election automatically transmuted LLC members into general partners for tax purposes. *Id.*

[13] *Swart,* No. F070922 at p.12.

[14] *Swart,* No. F070922 at p.13.

[15] *Swart,* No. F070922 at p.5. The Court of Appeal explained that LLC members have limited liability for the LLC's debts and obligations and hold no direct ownership interest in the LLC's specific property. *Swart,* No. F070922 at p.13. Moreover, although LLC members may generally participate in the management and control of the business, this ability depends on how management was vested in the LLC operating agreement and articles of incorporation. *Swart,* No. F070922 at p.13-14.

[16] In Franchise Tax Board Legal Ruling 2014-01 (July 22, 2014), the FTB concluded that a member corporation holding a 15 percent interest in an LLC that was not incorporated, organized, or registered to do business in California and had no presence in California other than its LLC membership must file a return and pay all taxes and fees resulting solely from its membership interest in the LLC. *See also Swart,* No. F070922 at p.15-16. In *Swart,* the Court of Appeal also stated that "[t]o the extent the arguments on appeal were also derived from the FTB's legal ruling, we disagree with its analysis and note it contradicts the position previously taken by the FTB" as articulated in Technical Advice Memorandum No. 200658 (Dec. 22, 2000). *Swart,* No. F070922 at p.15. In Technical Advice Memorandum No. 200658, the FTB relied on *Amman & Schmid,* when it concluded that, for purposes of doing business, where an out-of-state LLC member was a separate entity and received California source income from the LLC, the out-of-state LLC member was not considered to be doing business in California. *Swart,* No. F070922, n.4.

[17] *Id.*

[18] *See e.g.,* FTB Legal Ruling 2014-01.

LLC fees. Moreover, corporate non-managing members of an LLC taxed as a partnership remain subject to the Corporation Income Tax under CRTC Section 23501 based on that corporation's distributive share of California source income from the LLC.

Contacts:

If you have questions regarding this California Court of Appeal decision or other California tax matters, please contact any of the following Deloitte Tax professionals:

Christopher Campbell
Principal, California Technical/Controversy Lead
Deloitte Tax LLP, Los Angeles
+1 213 553 3072
cwcampbell@deloitte.com

Steve West
Managing Director, California Technical Lead
Deloitte Tax LLP, Los Angeles
+1 213 688 5339
stevewest@deloitte.com

Keith Gray
Managing Director
Deloitte Tax LLP, San Francisco
+1 415 783 6340
kegray@deloitte.com

Shirley J. Wei
Senior Manager, California Technical/Controversy Lead
Deloitte Tax LLP, Los Angeles
+1 213 553 1715
shiwei@deloitte.com

Valerie C. Dickerson
Partner, Washington National Tax
Deloitte Tax LLP, Washington DC
+1 202 220 2693
vdickerson@deloitte.com

The authors of this alert would like to acknowledge the contributions of Lili Sowlati to the drafting process. Lili is a Tax Consultant working in the Orange County Multistate Tax practice of Deloitte Tax LLP.

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