

California Franchise Tax Board Releases Legal Ruling Addressing Nexus for Members of LLCs Classified as Partnerships

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Overview

On July 22, 2014, the California Franchise Tax Board (“FTB”) issued Legal Ruling (“LR”) 2014-01, which addresses when a business entity¹ is required to file a California franchise/income (hereinafter “income”) tax return and is subject to California income tax based on its membership interest in a multi-member limited liability company (“LLC”) that has elected to be treated as a partnership for federal and state income tax purposes.² In LR 2014-01, the FTB explains that, if the LLC is doing business in California, its members will also be treated as doing business in California. LR 2014-01 also provides that a member of a LLC is not considered to be doing business in California and is not required to file a California tax return or pay the \$800 minimum tax if the LLC is not doing business in California and files a California tax return solely because it is formed under California’s LLC Act or is registered with the California Secretary of State. In this Tax Alert we summarize LR 2014-01 and provide taxpayer considerations.

Consequences for Business Entities that are Members of Multiple-Member LLCs Classified as Partnerships for Tax Purposes

LR 2014-01 formalizes the FTB’s position with respect to the California income tax and tax return filing requirements of members of multiple-member LLCs classified as partnerships for California income tax purposes. Specifically, if a LLC meets the “doing business” standard set forth in California Revenue & Taxation Code (“CRTC”) Section 23101, its members will also be treated as doing business in California regardless of whether its members exceed the sales, property, and payroll thresholds contained in CRTC Section 23101, and regardless of whether the member is a managing or a non-managing member.³ Citing California’s LLC Act, the FTB concludes that even non-managing members have the right to manage and conduct the LLC’s business.⁴ LR 2014-01 contains six examples of the application of the California doing business standard to LLCs and their members.⁵ In the first two examples the LLC is not doing business in California.⁶ However, it is required to file a tax return and is subject to the \$800 minimum tax and the LLC fee because it is either registered with the California Secretary of State or formed under California law.⁷ In these two examples, the FTB concludes that a corporate member is not doing business in California and is not required to file a California tax return because the LLC is not actually doing business in the state.⁸ In each of the remaining examples the FTB concludes that the corporate member is doing business in California because the LLC is doing business in the state.⁹

The FTB continues to maintain its position that *Amman & Schmid* does not apply to non-managing members of LLCs.¹⁰ In *Amman & Schmid*, the State Board of Equalization (“SBE”) carved out a limited exception to the “doing business” standard of CRTC Section 23101(a) with respect to limited partners of limited partnerships.¹¹ In LR 2014-01, the FTB concludes that the SBE’s decision hinged on the right to manage or control the decision making process of the entity, not whether a partner had limited liability.¹² The FTB contrasts the rights of general partners,

¹ LR 2014-01 does not specifically address LLC members that are individuals.

² FTB Legal Ruling 2014-01 (Jul. 22, 2014), available at: https://www.ftb.ca.gov/law/rulings/active/lr14_01.pdf.

³ *Id.* at 4.

⁴ *Id.*

⁵ *Id.* at 5-11.

⁶ *Id.* at 5-7.

⁷ *Id.*

⁸ *Id.* at 6-7.

⁹ *Id.* at 7-11.

¹⁰ *Appeal of Amman & Schmid Finanz AG*, 96-SBE-008 (Cal. St. Bd. of Equal. April 11, 1996).

¹¹ *Id.*

¹² FTB Legal Ruling 2014-01 (Jul. 22, 2014), at 5.

who have the right to control and manage the partnership, with those of limited partners, who have no such rights.¹³ Accordingly, the FTB reasons, because the default rules in California's LLC act provide all members the right to manage the LLC, all members of LLCs should be treated similar to general partners in the partnership context and the LLC's activities should be attributable to its members.¹⁴ Although non-managing members may delegate their management rights to a managing member, the FTB notes they also have the power to revoke their delegation at any time, thereby retaining ultimate authority over the management of the LLC.¹⁵ Therefore, if an LLC that is classified as a partnership for tax purposes is doing business in California, its members will be deemed to be doing business in California, notwithstanding their limited liability protection.¹⁶

Taxpayer Considerations

LR 2014-01 explicitly provides a limited exception for members of LLCs that are merely organized or registered in California. As long as the LLC is not actually doing business in the state, the members of these LLCs will not be subject to California's \$800 minimum franchise tax and filing requirements merely by virtue of their ownership in the LLC.¹⁷ Taxpayers should examine the activities of any LLCs in which they hold an ownership interest to determine whether the LLC files a California tax return solely because of its formation under California law or registration with the Secretary of State. Certain taxpayers may no longer have a California income tax return filing obligation and may be entitled to refunds of amounts paid in prior years.

It is unclear whether the issuance of LR 2014-01 will change existing FTB filing enforcement practices. Currently, the FTB filing enforcement unit often contacts all LLC members receiving California K-1s who have not filed a California income tax return, regardless of whether the K-1 reports California source income or deductions. It remains to be seen whether the FTB will modify these procedures or continue to contact taxpayers receiving California K-1s who have not filed a California return. Unless the procedures are adjusted, LLC members who are now protected by LR 2014-01 may have to respond to FTB notices on a case by case basis.

Although the examples in LR 2014-01 highlight a corporate member of the LLC to illustrate when a member is doing business in California, the same principles may be applicable to a LLC member which is another LLC or a limited partnership. As result, the exceptions to the tax return filing requirement in the first two examples may potentially reduce the compliance burden in tiered flow-through entity structures.

In footnote 19 of LR 2014-01 the FTB affirmatively states that limited partners in limited partnerships whose distributive share of California property, payroll or sales (when combined with its interest in other pass-through entities) do not exceed the thresholds in CRTC Sections 23101(b)(2), (3) and (4) will not be deemed to be doing business.¹⁸ The FTB's statement should allay concerns that *Amman & Schmid* was superseded by the enactment of the economic nexus provisions in CRTC Section 23101.

Taxpayers should also be aware that there is active litigation addressing the issue of doing business as defined prior to the changes made to CRTC Section 23101 (effective for tax years beginning on or after January 1, 2011). In 2007, Swart Enterprises, Inc. (Swart), a corporation with its principal place of business in Iowa, held a .02% investment interest in a multi-member "manager-managed" LLC doing business in California.¹⁹ Swart has challenged the FTB's position that the mere holding of its interest subject it to the California minimum franchise tax under CRTC Section 23153.²⁰ The final resolution of this litigation may have implications as to application of LR 2014-01 and potentially provide relief for similarly-situated taxpayers.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 4-5.

¹⁶ *Id.* at 4.

¹⁷ *Id.* at 3-11.

¹⁸ *Id.* at 5.

¹⁹ *Swart Enterprises, Inc. v. Franchise Tax Bd.*, Fresno County Superior Court Case No. 13 CE CG 02171 (July 9, 2013).

²⁰ *Id.*

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