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Multistate Tax
EXTERNAL ALERT

Non-managing Member of LLC Held Not Doing Business in California

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Overview

A California Superior Court (trial court) recently issued a ruling in favor of the taxpayer in *Swart Enterprises, Inc. v. California Franchise Tax Board* ("*Swart*").[1] In its ruling the court concluded that an Iowa corporation, whose only connection to California was its passive membership in a manager-managed California limited liability company ("LLC"), was not "doing business" in California and was therefore not subject to the $800 minimum franchise tax under Cal. Rev. & Tax. Code section 23151.[2] Although the Franchise Tax Board ("FTB") has not appealed the court's decision, the period for filing an appeal remains open and thus the case is not yet final.

In this Tax Alert we summarize the decision in *Swart* and provide some taxpayer considerations, including that corporate taxpayers paying more than the $800 minimum tax may not be impacted by this case because they may still be subject to the corporate income tax on California sourced income under Cal. Rev. & Tax. Code section 23501 instead of the corporate franchise tax.

Summary of Facts and Legal Positions in *Swart*

In *Swart* the taxpayer held a 0.2% ownership interest in an LLC taxed as a partnership for income tax purposes. The LLC was managed by a manager that was given exclusive and complete authority over business operations of the LLC under the terms of the LLC operating agreement. The taxpayer's only connection with California was its investment in the LLC.[3]

In ruling in favor of the taxpayer, the court found the analysis and reasoning in the *Appeal of Amman & Schmid Finanz AG*[4] highly supportive of the taxpayer's position. The court concluded that the taxpayer was not doing business in California because it had no interest in specific property of the LLC, was not personally liable for the LLC's obligations, played no role in the LLC's management (and had no right to do so) and, finally, could not act as an agent for the LLC or bind it in any way.

The court was also dismissive of the FTB's arguments based on Legal Ruling 2014-01.[5] It noted that the legal ruling was contrary to the FTB's position in a prior Technical Advice Memorandum[6] ("TAM"). It also pointed out that the FTB's analysis in the legal ruling relied heavily on the assumption that non-managing members of LLCs can delegate the power to manage the entity to a manager and revoke that delegation at any time, providing them with ultimate control over the manager and the LLC. However, the court found that control was not present in this case because the taxpayer, which was not one of the original members of the LLC that had delegated management powers to the manager, did not participate in the decision to appoint the manager and could not revoke the manager's powers because of the taxpayer's minimal interest in the LLC. Accordingly, the court concluded that the FTB's analysis, which depended on the taxpayer's right to control the LLC's business activities, was not persuasive.

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[1] *Swart Enterprises, Inc. v. California Franchise Tax Board*, Case No. 13CECG02171 (Cal. Super. Ct. hearing Nov. 13, 2014; Summary Judgment entered Nov. 20, 2014; Notice of entry of judgment filed on Nov. 25, 2014).
[2] *See also*, CAL. REV. & TAX. CODE § 23153(d).
[3] Note that the FTB had required the taxpayer to file a California tax return for the year ended June 30, 2010.
[4] *Appeal of Amman & Schmid Finanz AG, et al.,* 96-SBE-008, (Cal. St. Bd. Of Equal. Apr. 11, 1996).
[5] *See*, *California Franchise Tax Board Releases Legal Ruling Addressing Nexus for Members of LLCs Classified as Partnerships,* Deloitte Multistate Tax External Alert (Aug. 13, 2014), available **here**.
[6] In TAM 2000-0658, the FTB concluded that an out-of-state organization holding a membership interest in a California single-member LLC was not considered to be doing business in California due to its membership interest in the LLC. (TAM 2000-0658, Franchise Tax Board (Dec. 22, 2000)). Accordingly, while the organization was required to file income tax returns because it received California sourced income, it was not subject to the California franchise tax. *Id.* Notably, the court in *Swart* specifically stated that it agreed with the analysis set forth in the TAM.

Taxpayer Considerations

The Swart decision is subject to appeal and, accordingly, is not yet final. However, taxpayers should consider the potential effect of the trial court's reasoning in this case. For corporate taxpayers the impact of the trial court's decision in *Swart* may be very limited. Specifically, under the reasoning of this decision, corporations may not be subject to the $800 minimum franchise tax[7] if their connection to California is limited to passive ownership interests in manager-managed LLCs. However, they still may be subject to the corporate income tax on California sourced income under Cal. Rev. & Tax. Code section 23501 instead of the corporate franchise tax under Cal. Rev. & Tax. Code section 23151. These two corporate taxes are mutually exclusive with identical tax rates, except that there is no $800 minimum corporate income tax.[8] As a result, the *Swart* decision is moot to the extent the corporate income tax exceeds the $800 minimum franchise tax.

The reasoning in the *Swart* decision may be applicable to limited partnerships or LLCs that are non-managing members of LLCs whose only activity is that of holding an interest in a lower tier LLC with California source income. Thus, under the reasoning contained in *Swart*, the non-managing member may potentially no longer be subject to the $800 minimum franchise tax imposed on limited partnerships and LLCs, as well as the LLC fee imposed on LLCs.

It is important to note that although a non-managing member of an LLC may not be "doing business" in California and thus not subject to the franchise tax or LLC fee, the decision in *Swart* does not relieve a non-managing member of an LLC of its tax return filing requirement based on its distributive share of California sourced income. This distinction is especially significant for flow-through entity members, such as partnerships, because the failure to comply with the filing requirements may result in significant per-partner penalties.

Similarly, nonresident individuals are not impacted by *Swart* and continue to be subject to the California personal income tax on California sourced income.

Taxpayers whose facts align with those in *Swart* should consider the continued payment of the minimum franchise tax until this case is ultimately resolved. However, taxpayers may also consider filing protective refund claims in light of *Swart* for all open years to preserve their rights to potential refunds.

Even if the *Swart* decision becomes final, its impact may be limited for many taxpayers for tax years beginning on or after January 1, 2011, due to California's bright-line nexus standard, which provides nexus thresholds based on a minimum level of sales, property or payroll within California.[9] Taxpayers whose allocable share of an LLC's sales, property or payroll exceeds any of the thresholds would still be considered doing business in California and thus subject to the applicable franchise tax and LLC fees.

Contacts

If you have questions regarding this California trial court decision or other California tax matters, please contact either of the following Deloitte Tax LLP professionals.

Keith Gray	Steve West
Director	Director
Deloitte Tax LLP, San Francisco	Deloitte Tax LLP, Los Angeles
kegray@deloitte.com	**stevewest@deloitte.com**
(415) 783-6340	(213) 688-5339

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[7] CAL. REV. & TAX. CODE § 23153(d).

[8] The two corporate taxes are imposed on the same measure of income at the same tax rates. Corporate taxpayers are subject to the corporate income tax on California sourced income even though they are not doing business in California. Corporations subject to the corporate income tax that report losses have no California tax liability. In contrast, corporations doing business in the state and subject to the corporate franchise tax owe the $800 minimum franchise tax even if they report a loss.

[9] CAL. REV. & TAX. CODE § 23101. For taxable years ending after 2013 the thresholds are the lessor of 25% of the entity's total receipts, property or payroll for the year or receipts exceeding $529,562, property exceeding $52,956 or payroll exceeding $52,956.

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