

California issues Legal Ruling 2019-02 on disregarded limited partnerships (not LLCs)

Overview

On November 20, 2019, the California Franchise Tax Board (FTB) issued Legal Ruling 2019-02 (Ruling) addressing the filing requirements for limited partnerships that are treated as disregarded for U.S. income tax purposes (federal DLP).¹ This ruling does not apply to disregarded limited liability companies (LLCs).

The Ruling states that federal DLPs, similar to the one at issue in the Ruling, are not subject to the California annual limited partnership tax and partnership tax return filing requirements under California Revenue and Taxation Code (CRTC) sections 17935 and 18633, respectively. In addition, the FTB issued FTB Notice 2019-06 (Notice) on November 20, 2019 addressing methods of substantiating disregarded entity status for limited partnerships.²

This tax alert summarizes the Ruling and Notice, as well as provides certain taxpayer considerations.

Background

A limited partnership is treated as a disregarded entity for U.S. income tax purposes under IRC section 7701, and the regulations thereunder, in certain situations. As noted in the Ruling, if an entity is disregarded for U.S. income tax purposes, then it is treated as essentially a division of its owner or sole proprietorship.

The Ruling arose in the context of a taxpayer-partner (a regarded entity for federal income tax purposes) that is a partner in a domestic (U.S.) limited partnership. Each of the other partners are wholly-owned by the taxpayer-partner and are disregarded entities for U.S. income tax purposes.³ As a result, the taxpayer-partner is treated as the sole owner of the limited partnership, which defaults to a disregarded entity for federal income tax unless it elects to be classified as an association taxable as a corporation.⁴

California analysis and holding

California generally conforms to the federal entity classification rules under IRC section 7701 for eligible business entities.⁵ As a result, pursuant to CRTC section 23038(b)(2)(B)(iii), limited partnerships disregarded for federal income tax purposes are also generally disregarded for California income and franchise tax purposes, and therefore are not required to file a California tax return or pay the \$800 annual tax. CRTC section 23038(b)(2)(B)(iii) provides some exceptions to the general rule that apply to LLCs including requiring disregarded LLCs to pay the \$800 annual tax to file a California tax return as well as pay an LLC fee (if applicable). However, the Ruling notes that no such exception exists for disregarded *limited partnerships*.⁶ As such, the Ruling concludes that federal DLPs (as described in the scenario above) are not required to pay the annual limited partnership tax under CRTC section 17935 or file a partnership tax return pursuant to section CRTC 18633.⁷

Procedural steps to establish limited partnership is disregarded

The FTB also issued Notice 2019-06, which sets forth procedures that taxpayers should take if receiving a Filing Enforcement Notice (or has a refund claim) regarding a properly disregarded limited partnership.⁸ To substantiate that the entity is properly disregarded, taxpayers should provide either (1) the certificate of limited partnership, partnership agreement, organizational chart, and federal returns of the partners for the year(s) in question, or (2) a declaration signed under penalty of perjury by the general partner stating that the entity was disregarded for federal

¹ FTB Legal Ruling 2019-02 (November 20, 2019), available [here](#).

² FTB Notice 2019-06 (November 20, 2019), available [here](#).

³ See FTB Legal Ruling 2019-02, pp. 1-2 (citing I.R.C. § 7701; 26 C.F.R. § 301.7701-2(c)(2)).

⁴ See *Id.* (citing also IRS Rev. Rul. 2004-77).

⁵ Cal. Rev. & Tax Code § 23038(b)(2)(B)(iii).

⁶ *Id.*

⁷ FTB Legal Ruling 2019-02 (November 20, 2019), p. 2.

⁸ FTB Notice 2019-06 (November 20, 2019).

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income tax purposes for the respective tax years.⁹ The FTB will review the documentation and determine whether the limited partnership has sufficiently established that it is disregarded for federal income tax purposes, and therefore is not subject to the California annual limited partnership tax and partnership tax return filing requirements.¹⁰

Considerations

This administrative guidance does *not* apply to disregarded LLCs as existing California tax laws specify that disregarded LLCs must pay the \$800 annual tax, LLC fee (if applicable) and file a California tax return. However, the current law does not extend those requirements to disregarded limited partnerships. Accordingly, pursuant to the Ruling and Notice 2019-06, DLPs will not be required to pay the \$800 annual tax and file a California tax return.

The FTB is proposing amendments to CRTC sections 23038 and 18633 to require disregarded limited partnerships to pay the \$800 annual tax and to file a California tax return.¹¹ This proposed legislative amendment was on the agenda for discussion at the FTB Board Meeting held on December 3, 2019.¹²

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⁹ *Id.* If the limited partnership's general partner is a LLC, the manager or the authorized member of the LLC must sign the declaration.

¹⁰ *Id.*

¹¹ See FTB Agenda for December 3, 2019 FTB Meeting, available [here](#); see also FTB Legislative Proposal C Executive Summary, available [here](#).

¹² *Id.*

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