



December 2014

Follow @Paul\_Hastings



## *Victory for Out-of-State Members in LLCs “Doing Business” in California*

BY [DOUGLAS A. SCHAAF](#) & [ERIKA MAYSHAR](#)

The California Franchise Tax Board (“FTB”) has taken an increasingly aggressive stance in recent years regarding its ability to tax out-of-state taxpayers with tenuous connections to California. The FTB has focused in particular on limited liability companies (“LLCs”), taking the position that the unique nature of LLCs can cause out-of-state passive members to be subject to California taxes even in the absence of any California-source income. One out-of-state investor challenged the FTB in court and recently won at the summary judgment stage of litigation.

### ***“Doing Business” in California***

Any entity that is “doing business” in California must file an annual tax return and pay a minimum \$800 annual tax “for the privilege of doing business in this state”.<sup>1</sup> Failure to comply can result in interest and penalties, including an annual \$2,000 failure-to-file penalty under certain circumstances.<sup>2</sup> The annual minimum tax is due even from entities with zero net income from California sources.

The statutory definition of “doing business” seems straightforward: “actively engaging in any transaction for the purpose of financial or pecuniary gain or profit”.<sup>3</sup> In 2011, various factors were added to the statute to clarify that it applies to any entity formed under California law or having in-state sales, property, or payroll exceeding certain thresholds.

The FTB has interpreted the “doing business” concept broadly, particularly as applied to LLCs.<sup>4</sup> The FTB’s stated positions extend to non-California business entities and their owners in unexpected ways.

### ***The Swart Case***

One such business was Swart Enterprises, Inc. (“Swart”), an Iowa corporation that owned a 0.2% interest in a California investment fund formed as an LLC (the “Fund”). Swart’s only connection to California was its passive interest in the Fund. The Fund was managed by a California corporate manager and invested in capital equipment in various states, including in California.

While the Fund filed California tax returns, Swart did not, presumably because it had no California-source income (either directly or through allocation from the Fund). The FTB demanded a return from Swart and imposed the \$800 minimum tax, interest, and penalties.

Swart paid the tax and filed a claim for refund as required under California law, and ultimately sued for a refund in a California state court.<sup>5</sup> Swart argued that it had not actively engaged in business in

California as required by the statute, and that its mere passive membership interest in the Fund should not subject it to California taxation.

Swart cited a 1996 opinion of the California State Board of Equalization,<sup>6</sup> which concluded that an out-of-state corporation was not subject to California income tax merely because of its limited partnership interest in a partnership doing business in California. This opinion had distinguished between limited and general partners, concluding that the business activities of a partnership could be attributed to the general partner but not the limited partners, due to limited partners' passive role and lack of management rights.

The FTB argued that because state law gives all members of an LLC the authority to manage its operations, passive members in an LLC are different than limited partners in a partnership. It is irrelevant whether an LLC's members have delegated managerial authority to an external manager, as in *Swart*. The business activities of an LLC are attributed to its members, who are considered to be engaged in those activities directly — meaning that if an LLC is “doing business” in California, so are all of its members.

On November 14, 2014, the court issued an order granting Swart's motion for summary judgment, holding that Swart was not doing business in California and was not subject to the \$800 minimum tax. The court disagreed with the FTB's narrow focus on LLC members' management authority under state law, and instead discussed the realities of the situation. Swart was a small, inactive investor in the Fund and the operating agreement dictated a manager-managed LLC with punitive consequences for removal of the manager. Swart did not have the authority to manage or control the Fund's decision-making, and therefore it was akin to a limited partner rather than a general partner.

### ***FTB Legal Ruling 2014-01***

The FTB issued a legal ruling during the *Swart* litigation, outlining its position on LLC and member taxation under various scenarios.<sup>7</sup> The following table summarizes the FTB's positions stated in the ruling. In each scenario, the LLC member is assumed to be a corporation holding a 15% interest in the LLC. The member is not incorporated in California, has no activities outside of its membership interest that would constitute “doing business” in the state, and has no California-source income.

Scenario	Is the LLC Required to File a CA Tax Return and Pay CA Taxes?	Is a Passive Member of the LLC Required to File a CA Tax Return and Pay CA Taxes?
<ul style="list-style-type: none"> <li>▪ Out-of-state LLC is registered with the Secretary of State to do business in California.</li> <li>▪ LLC does <u>not</u> meet any of the statutory activity thresholds for California taxation.</li> </ul>	Yes.	No. Mere registration of LLC in CA is not sufficient member-attributed business activity.
<ul style="list-style-type: none"> <li>▪ LLC is formed under California law.</li> <li>▪ LLC does <u>not</u> meet any of the statutory activity thresholds for California taxation.</li> </ul>	Yes.	No. Mere formation of LLC in CA is not sufficient member-attributed business activity.

<ul style="list-style-type: none"> <li>▪ LLC's commercial domicile (day-to-day management) is in California.</li> <li>▪ LLC does <u>not</u> meet any of the statutory activity thresholds for California taxation.</li> </ul>	Yes.	Yes.
<ul style="list-style-type: none"> <li>▪ LLC <u>does</u> meet one or more of the statutory activity thresholds for California taxation.</li> <li>▪ LLC is member-managed.</li> </ul>	Yes.	Yes.
<ul style="list-style-type: none"> <li>▪ LLC <u>does</u> meet one or more of the statutory activity thresholds for California taxation.</li> <li>▪ LLC is manager-managed.</li> </ul>	Yes.	Yes, per the FTB. No, per <i>Swart</i> , where member has no management authority.

## Implications

Why should taxpayers care about an \$800 victory for *Swart*?

The LLC in which *Swart* invested had hundreds of other investors, most of whom were outside of California. The FTB's position would have turned all of these investors into California taxpayers. Investments such as this are frequently made through special purpose vehicles and multi-tier pass-through structures. Under the FTB's aggressive interpretation, it is possible that one entity deemed to be "doing business" within California could trigger annual filing requirements for many parties, resulting in both tax costs and disclosure costs.

Despite the favorable outcome in *Swart*, out-of-state taxpayers should proceed with caution. The order is unpublished and therefore cannot be relied upon as precedent in a legal action, although it is instructive and could be persuasive in dealings with the FTB. The FTB generally has a 60-day window in which to appeal.

Moreover, the *Swart* ruling is limited to manager-managed LLCs, and does not address various other scenarios that might cause non-California investors to become subject to California taxation. For example, it appears that the FTB believes that if a Delaware LLC is member-managed and has at least one California member, all of the LLCs members are "doing business" in California. It is unclear how far the FTB would extend this approach, particularly where multi-tier structures are involved. Until more clarity is developed on these issues, non-California taxpayers might consider adopting limited partnership structures instead of LLC structures if there are not compelling business reasons to choose one form of entity over the other, in order to limit the attribution of activities from the entity to its owners and vice versa.<sup>8</sup>

Confusion often arises because the FTB and the California Secretary of State have different interpretations of the level of in-state business activity that triggers their respective filing requirements. It is quite possible that a non-California business entity might be exempt from registration requirements because it is not "transacting intrastate business" in the view of the Secretary of State,<sup>9</sup> but is nevertheless required to file California tax returns because it is "doing business" in the view of the FTB.



*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

## Los Angeles

Alexander Lee  
1.213.683.6160  
[alexanderlee@paulhastings.com](mailto:alexanderlee@paulhastings.com)

## Orange County

Douglas A. Schaaf  
1.714.668.6221  
[dougschaaf@paulhastings.com](mailto:dougschaaf@paulhastings.com)

## Palo Alto

Thomas S. Wisialowski  
1.650.320.1820  
[thomaswisialowski@paulhastings.com](mailto:thomaswisialowski@paulhastings.com)

Erika Mayshar  
1.714.668.6262  
[erikamayshar@paulhastings.com](mailto:erikamayshar@paulhastings.com)

- 
- <sup>1</sup> Cal. Rev. & Tax. Code § 17935 (limited partnerships); *id.* § 17941 (LLCs); *id.* § 23153 (C corporations); *id.* § 23802 (S corporations).
- <sup>2</sup> Section 19135 of the Revenue and Taxation Code was recently amended to impose a \$2,000 penalty upon a nonqualified or forfeited foreign corporation or LLC, or a suspended domestic corporation or LLC, doing business within California that fails to file a return within 60 days after being contacted by the FTB.
- <sup>3</sup> Cal. Rev. & Tax. Code § 23101(a).
- <sup>4</sup> All references to LLCs in this article refer to LLCs that are taxed as partnerships under the default rules, rather than having elected to be taxed as corporations.
- <sup>5</sup> *Swart Enterprises, Inc. v. Franchise Tax Board*, No. 13CECG02171, (Fresno Super. Ct. filed July 9, 2013) (unpublished).
- <sup>6</sup> *In re Appeals of Amman & Schmid Finanz AG*, No. 92N-0520, 1996 Cal. Tax LEXIS 62 (April 11, 1996).
- <sup>7</sup> Legal Ruling 2014-01.
- <sup>8</sup> Note, however, that even a limited partner's distributive share of sales, property, or payroll can cause it to meet the "doing business" standard if the partnership exceeds the thresholds stated in Cal. Rev. & Tax. Code § 23101.
- <sup>9</sup> Before "transacting intrastate business" in California, foreign entities must register with the Secretary of State. Cal. Corp. Code § 2105 (corporations); *id.* § 15909.02 (limited partnerships); *id.* § 17708.02 (LLCs). Various exceptions apply.

## Paul Hastings LLP

StayCurrent is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2014 Paul Hastings LLP.