State & Local Tax **Alert**

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California Court of Appeal Holds Small Non-Managerial Interest in LLC Does Not Constitute Doing Business in State

On January 12, 2017, the California Court of Appeal held that an out-of-state corporation whose sole connection with the state was a passive 0.2 percent ownership interest in a manager-managed California limited liability company (LLC) did not constitute "doing business" for purposes of the California corporation franchise (income) tax.[1] The corporation's interest in the LLC closely resembled a limited partnership interest because it had no ability to participate in the management and control of the LLC. Because a partnership's business activities cannot be attributed to a limited partner, the corporation could not be deemed to be doing business in California solely by virtue of its ownership interest in the LLC.[2]

Background

Swart Enterprises, Inc., an Iowa corporation, invested $50,000 in an existing manager-managed California LLC investment fund in 2007. This $50,000 investment represented an ownership interest in the LLC of approximately 0.2 percent, and was the only business connection that Swart had with the state of California. A separate California corporation had exclusive and complete authority in the management and control of the LLC. The LLC's operating agreement provided that members other than the manager were prohibited from taking party in the control or operation of the LLC. In 2009 and 2010, the LLC elected to be taxed as a partnership under federal and state law.

The California Franchise Tax Board (FTB) required that Swart file a California corporation franchise tax return for the tax year ending June 30, 2010. According to the FTB, Swart was doing business in California and subject to the $800 minimum corporation franchise tax due to its ownership interest in an LLC operating in the state. After paying the tax, interest and penalties under protest, Swart filed a refund claim for these amounts. Swart and the FTB both filed motions for summary judgment.

A California superior court granted Swart's motion for summary judgment and determined that Swart's ownership interest in the LLC did not constitute doing business in

[1] *Swart Enterprises, Inc. v. Franchise Tax Board*, California Court of Appeal, Fifth Appellate District, No. F070922, Jan. 12, 2017. This decision is binding and has been certified for publication.
[2] The Court of Appeal did not need to consider the taxpayer's constitutional arguments.

Release date
January 30, 2017

States
California

Issue/Topic
Corporation Income Tax

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the state.[3] Although the LLC was treated as a partnership for federal and state income tax purposes, Swart was not doing business in the state by reason of its ownership interest in the LLC, because it did not have the right to manage or control the LLC's decision-making process. The FTB appealed this decision to the California Court of Appeal.

Taxpayer Was Not Doing Business Under Plain Statutory Language

In affirming the trial court, the Court of Appeal held that Swart was not doing business in the state under the plain language of the relevant statutes. Under California law, corporation franchise tax is imposed on the net income of every corporation "doing business within the limits of this state."[4] A statute defines "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."[5] According to the California Supreme Court, the term "actively" is the opposite of "passively" and means "active transaction for pecuniary gain or profit."[6] In this case, the Court of Appeal was not persuaded that Swart's investment in the LLC was sufficient to support a conclusion that Swart was doing business in California. The $800 minimum franchise tax was imposed several years after Swart made its investment and became a member of the LLC. The Court rejected the Attorney General's argument that "doing business" should be interpreted broadly to include Swart's passive investment.

LLC's Taxation Election Did Not Make Taxpayer a General Partner

The Court of Appeal rejected the Attorney General's argument that Swart was a general partner based on the LLC's election to be treated as a partnership for federal income tax purposes. The Attorney General unsuccessfully argued that Swart was doing business in California because a partnership's activities can be attributed to a general partner. The Court noted that the state did not provide any legal authority to support the conclusion that an LLC member is transformed into a general partner merely because the LLC makes an election for federal income tax purposes to be treated as a partnership.

Swart argued that an LLC is a separate entity from its owners. An LLC's decision to be taxed as a partnership for federal income tax purposes does not mean that the separate entity status may be disregarded for all tax purposes, including the California corporation franchise tax. To support this argument, Swart referenced a case that stands for the proposition that a taxation election does not control for all tax purposes.[7] Even if the taxation election were relevant in determining whether a member of an LLC is doing business in California, the Court determined that the Attorney General's argument was flawed because it did not distinguish between a general partnership interest and a limited partnership interest.

In finding that Swart was not doing business in California, the Court relied on a decision of the California State Board of Equalization (SBE), *Appeals of Amman & Schmid Finanz*

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[3] For a discussion of this decision, see GT SALT Alert: California Court Holds Non-Managerial Interest in LLC Did Not Constitute Doing Business in State.

[4] CAL. REV. & TAX. CODE § 23151(a).

[5] CAL. REV. & TAX. CODE § 23101(a).

[6] *Golden State Theatre & Realty Corp. v. Johnson*, 133 P.2d 395 (Cal. 1943); *Hise v. McColgan*, 148 P.2d 616 (Cal. 1944).

[7] *Pierre v. Commissioner*, 133 T.C. 24 (2009).

AG,[8] recognizing "a limited partner is not 'doing business' merely by virtue of its ownership interest in a limited partnership." In *Amman*, foreign corporations acquired limited partnership interests in descending tiers of limited partnerships. The limited partnerships at the bottom tier were doing business in California, but the FTB argued that the foreign limited partners also were doing business in the state because the general partners were executing business transactions in the state as agents for the limited partnerships and the partners. In summarizing the holding of this decision, the Court explained that the "SBE concluded the corporate limited partners could not be doing business in California simply because they owned interests as limited partners in partnerships engaged in business in California because '[a] general partner simply does not have agency rights over the obligations or the property of the limited partners.'" The Court concluded that *Amman* strongly supported the conclusion that Swart was not doing business in California because its ownership interest was very similar to the limited partnership interest that was at issue in *Amman*.

Taxpayer's Interest Was Comparable to Limited Partnership

Swart successfully argued that it could not be deemed to be doing business in California based solely on holding a membership interest in an LLC because Swart effectively was a limited partner with no right to manage or control the LLC. The operating agreement provided for a manager-managed LLC. Because Swart was not authorized to manage or control the LLC, the relationship between the entities supported the conclusion that Swart was a "quintessential passive investor." Swart's interest in the LLC was essentially a limited partnership interest because Swart had no authority to participate in management and control of the fund, it was not liable for the fund's debts and obligations, it did not own an interest in any of the fund's specific property and it could not act on the fund's behalf.

The Attorney General argued that members of an LLC are doing business in California due to their ownership interest regardless of whether they are members of a member-managed LLC or a manager-managed LLC. The FTB took this position in Legal Ruling 2014-01,[9] which the FTB issued while this case was pending. The Court explained 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."

In Legal Ruling 2014-01, the FTB clarified that in situations where an LLC is classified as a partnership for tax purposes and is doing business in California, all of its members are also doing business in the state. According to the FTB, a member of a manager-managed LLC is doing business in the state because the members have the right to exercise some control over the LLC. For example, these members relinquish control of the LLC to the manager and have authority to remove the manager. Based on this logic, the Attorney General argued that Swart had the right to control the fund, even though it was manager-managed. In rejecting this argument, the Court noted that Swart never had any control to relinquish because the LLC was established as a manager-managed LLC two years before Swart became an investor. Thus, Swart had no right to control or influence the designation of

[8] No. 96-SBE-008, California State Board of Equalization, April 11, 1996.

[9] California Franchise Tax Board, July 22, 2014. For further discussion of this document, see GT SALT Alert: California Issues Legal Rulings Addressing Nexus and Apportionment Issues.

the LLC as a manager-managed fund. Furthermore, due to Swart's minimal ownership interest, it could not have removed the manager on its own.

The Court concluded that Swart was not doing business in California based on its minority ownership of the LLC. According to the Court, "[t]he Attorney General's conclusion that a taxation election could transmute Swart into a general partner for purposes of the franchise tax, and that the business activities of [the LLC] can therefore by imputed to Swart, is not supported by citation to appropriate legal authority and, in our view, defies a commonsense understanding of what it means to be 'doing business.'"

Commentary

This taxpayer-favorable decision limits the FTB's ability to impose corporation franchise tax on out-of-state corporations that have a passive interest in a California LLC. As a binding and published appellate decision, it affects the FTB's ability to impose corporation franchise tax on out-of-state corporations that have no ability to control or manage the decision-making process of the California entity. Also, this decision precludes the FTB from expanding nexus based on Legal Ruling 2014-01, a document prepared in part with this controversy in mind. Despite the FTB's argument, the fact that an LLC is classified as a partnership for income tax purposes does not automatically treat an out-of-state owner as a general partner subject to California corporation franchise tax. If the out-of-state owner does not have the right to manage the LLC and has a small, non-controlling ownership interest in the LLC, there is a strong argument to distinguish this passive interest from an ownership interest in which the out-of-state owner actively controls and manages the LLC.

Private equity and hedge funds that have multiple tiers of entities receiving California Schedule K-1 statements should note that this decision may affect their filing and tax reporting obligations. This decision affirms the applicability of *Amman*, which ruled that an out-of-state limited partner of a California limited partnership is not doing business in the state, to members of manager-managed LLCs. The FTB previously maintained that *Amman* protection only applied to partners of a limited partnership, not to members of an LLC, and the FTB did not make a distinction between member-managed and manager-managed LLCs. In this case, the Court of Appeal affirmed the superior court's decision that *Amman* protection applies to certain LLC members. However, note that this decision only applies to manager-managed LLCs. Members of member-managed LLCs are advised to exercise caution because the FTB may narrowly apply this decision and limit it to members of manager-managed LLCs.

This decision may be relevant to certain investment funds and other pass-through entities. Although this decision concerned the doing business requirement for the $800 minimum tax and the corporation franchise tax, it did not address the filing requirements of a limited partnership or an LLC due to California source income from an underlying LLC investment. Out-of-state partnerships generally are required to file partnership returns in California if they are doing business in the state ***or*** receive California source income. Accordingly, an out-of-state pass-through entity that is a member of a California LLC may be able to claim an exemption under this decision from the $800 limited partnership tax, the $800 LLC tax and the LLC fee on gross receipts. However, the entity may still have an obligation to file California partnership tax returns and issue California K-1 statements to its partners due to the receipt of California source income through an LLC investment. Even if the amount of income reported on a California K-1 is minimal, a partnership that receives a California K-1 may still be required to file a tax return in California despite having protection under this decision. Because California non-filing penalties imposed on a per-partner, per-month basis may be substantial, a partnership that has protection under this decision should carefully review whether it is nevertheless required to file a return in California.

It should be noted that this decision concerned a corporation franchise tax year that ended on June 30, 2010. For tax years beginning on or after January 1, 2011, California significantly expanded its "doing business" statute to include an economic nexus standard.[10] Therefore, out-of-state entities may have nexus with California for tax years beginning after 2010 under this new broader nexus standard. It is unlikely that the new nexus standard would have changed the outcome of the instant case because Swart probably did not meet any of the economic nexus thresholds due to its very small ownership interest in the LLC. Because this case concerned tax years beginning prior to 2011, the Court did not address the new economic nexus standard.

Based on this decision, it may be inferred that partners of a limited partnership and non-manager members of a manager-managed LLC should theoretically not take into account their share of the underlying factors from the entity for purposes of determining economic nexus under the bright-line standard. However, the state tax authority may not have reached the same conclusion at this point.

There may be a correlation between this decision and the current treatment of corporate entities and unitary versus non-unitary determinations. If a unitary relationship exists between a corporate partner and the underlying joint venture, the corporate partner is required to flow up its share of the partnership factors for apportionment purposes. This treatment should also apply where there are two-tiered unitary partnership relationships and extend to the upper tier corporation's economic nexus "doing business" determinations. In situations where there is an investment group and a limited partnership or a member-managed LLC, without serious overlap in leadership, it would seem difficult for a unitary relationship to exist which would require a look-through treatment of the underlying factors as if the member or partner owned them directly.

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[10] CAL. REV. & TAX. CODE § 23101(b). Under this standard, a taxpayer is considered to be doing business in California for a taxable year if any of the following conditions are satisfied: (i) the taxpayer is organized or commercially domiciled in the state; (ii) the taxpayer's sales applicable for the taxable year exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales; (iii) the taxpayer's real property and tangible personal property in California exceed the lesser of $50,000 or 25 percent of the taxpayer's total real property and tangible personal property; or (iv) the amount of compensation paid by the taxpayer in the state exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.