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California Franchise Tax Board Issues Legal Ruling Regarding Taxation of Limited Liability Companies

The California Franchise Tax Board issued a legal ruling that discusses when a corporate member of a limited liability company classified as a partnership is required to report and pay taxes and fees.

SUMMARY

On July 22, 2014, the Franchise Tax Board (“FTB”) issued Legal Ruling 2014-01, in which the FTB discusses when a corporate member of a limited liability company (“LLC”) classified as a partnership for federal income tax purposes is required to report and pay California taxes and fees. The examples in Legal Ruling 2014-01 illustrate that a corporate member of an LLC classified as partnership for federal income tax purposes may have a California franchise tax reporting and payment obligation where the LLC is actively engaging in a transaction or activity in California for the purpose of financial or pecuniary gain or profit. However, a corporate member of an LLC classified as partnership for federal income tax purposes may not have such an obligation where the LLC is merely registered with the state or organized under the state’s laws.

DETAILS

In Legal Ruling 2014-01, the FTB first notes that: (1) California follows the federal entity classification system, (i.e., the “check-the-box” regulations); and (2) if an LLC is classified as a partnership for federal income tax purposes, both the LLC and its members should be subject to the same legal principles that apply to any partnership, including the State Board of Equalization’s decision in Appeals of Amman & Schmid Finanz AG, et al., 96-SBE-008 (Calif. Bd. of Equal., April 11, 1996) (corporate member that limits its California contact to the ownership of a limited partnership interest is not “doing business” in the state). The FTB then provides six examples (or “Situations”) that illustrate when an LLC and its corporate member have a franchise tax or LLC tax and fee reporting and payment obligation. The Situations may be summarized as follows:

- *Situations 1 and 2 – LLC Only Organized or Registered To Do Business in California* – If an LLC classified as a partnership for federal income tax purposes is organized or registered to do business in California, it has a California tax return filing requirement and it is subject to the LLC tax and fee – even though



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the LLC may not have California activity or a California factor presence.¹ However, a corporate member in the same LLC that does not have any contact with California but for its LLC interest does not have a California income tax return and payment obligation because the LLC's act of organization or registering to do business in California is not a transaction or activity for the purpose of financial or pecuniary gain or profit that is attributed to the corporate member.

- Situations 3, 4, and 6 – LLC “Doing Business” in California - If an LLC classified as a partnership for federal income tax purposes is actively engaging in any transaction for the purpose of financial or pecuniary gain, is commercially domiciled in California (i.e., the definition of the term “commercially domiciled” implies engaging in a transaction or activity for the purpose of financial or pecuniary gain or profit), or its property, payroll or sales exceed one of the statutory thresholds, it meets the definition of “doing business” under Cal. Rev. & Tax Code section 23101. Thus, the LLC has a California tax return filing requirement and is subject to the LLC tax and fee. In addition, a corporate member in the same LLC may have a California franchise tax reporting and payment obligation even if the corporate member limits its contact with California to the ownership of its interest in the LLC because the LLC’s “doing business” in this case is attributed to the corporate member.
- Situation 5 – “Manager-Managed” LLC “Doing Business” in California - An LLC’s classification as “member-managed” or “manager-managed” is irrelevant for purposes of determining whether a corporate member is subject to an income tax reporting and payment obligation.

¹ See Cal. Rev. & Tax Code §§ 17941(b)(1) and 18633.5(a).



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INSIGHTS

In many respects, Legal Ruling 2014-01 is a restatement of the FTB's position that a member of an LLC classified as a partnership for federal income tax purposes is "doing business" in California if the LLC is "doing business" in the state.² However, Legal Ruling 2014-01 does clarify that a corporate member is not necessarily "doing business" in the California if the LLC is only organized or registered to do business in the state.

Interestingly, the FTB notes in Legal Ruling 2014-01 that the decision in Amman & Schmid Finanz AG applies to an LLC classified as a partnership for federal income tax purposes. If true, it follows that if a corporate member of an LLC classified as a partnership for federal income tax purposes has the attributes of a limited partner or a limited partnership (e.g., no power to manage or conduct partnership business), then the corporate member may not be subject to California franchise tax if its only contact with the state is the ownership of its interest in the LLC.

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² See, e.g., General Information on New Rules for Doing Business in California, California Franchise Tax Board (March 4, 2011).

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