SALT WATCH

California Appellate Court Affirms that an Out-of-State Corporation with a Passive Investment in a California Limited Liability Company is Not "Doing Business" in California

Summary

On January 12, 2017, the California Court of Appeal, Fifth District, held that Swart Enterprises, Inc. ("Swart") was not "doing business" in California by virtue of owning a 0.2% non-managing interest in a Limited Liability Company ("LLC") that was doing business in California. The Court of Appeal ruled that Swart's LLC interest was a passive interest.

Details

Background

In 2007, Swart purchased a 0.2 percent non-managing interest in an LLC, which was doing business in California. The LLC was formed in 2005 and was designated as a manager-managed limited liability company. Swart had no physical presence in California, did not sell or market products or services in California, and was not registered with the California Secretary of State to transact business within the state. Swart's only connection to California was its ownership interest in the LLC doing business in the state.

For the 2009 and 2010 tax years, the LLC was treated as a partnership for federal and state tax purposes. In 2010, the LLC was not required to pay the California LLC fee because it had insufficient income; however, based on Swart's ownership interest in the LLC, the Franchise Tax Board (the "FTB") demanded that it file a corporate franchise tax return and pay the $800 minimum tax due on the return. Swart filed the return and paid the tax, penalties, and interest under protest and requested a refund.

California Appellate Court Rules in "Doing Business" in California Case (cont.)

Holding

The court held that holding a 0.2 percent passive ownership interest in an LLC, with no right of control over the business affairs of the LLC, does not constitute "doing business" in California under Cal. Rev. & Tax. Code § 23101. The court also held that Swart's LLC interest was comparable to a limited partnership interest. Further, the court rejected the state's reliance on Legal Ruling 2014-01 (July 22, 2014), which was issued during the pendency of the case.

• **No Broad Interpretation of "Doing Business" in California**. For tax years prior to January 1, 2011, California defined "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."(1) The California Attorney General argued that the term "doing business" should be interpreted broadly to include Swart's passive investment. The Court of Appeal disagreed, holding that prior judicial precedent did not require a broad interpretation, but rather distinguished between engaging in active and passive business.

• **LLC Interests are not Equivalent to General Partnership Interests.** Swart argued that it was not "doing business" in California solely by virtue of holding an ownership interest in an LLC doing business in California. As a passive investor, it had no right to manage or control the LLC's business operations. The court agreed, holding that Swart's interest in the LLC was comparable to a limited partnership interest because Swart "had no authority to participate in the management and control of the [LLC], it was not liable for the debts and obligations of the [LLC], it did not own an interest in specific property of the [LLC], nor could it act on behalf of the [LLC]." Therefore, Swart could not be deemed to be "doing business" in California.

• **Legal Ruling 2014-01 Rejected.** The Attorney General relied upon Legal Ruling 2014-01 (the "Ruling") as support that members of an LLC are doing business in California solely by virtue of an ownership interest in a LLC, regardless of whether the LLC is a member or manager-managed LLC. In the Ruling, the FTB concluded that a corporate member holding a 15 percent interest in an LLC must file a California corporation income and franchise tax return and pay all taxes and fees resulting from its membership interest. The Ruling's "doing business" conclusion did not change even though the corporate member was "not incorporated, organized, or registered to do business in California" and had "no presence in California other than its membership in the LLC." In addition, the Attorney General argued that Swart had the right to exercise control over the LLC, because it relinquished control to the manager. The court disagreed and stated Swart could not relinquish a right that it never held. In addition to having no right to control or influence the LLC's business, the court noted that, even if Swart had such right, its 0.2 percent interest rendered any such influence minimal.

(1) Former Cal. Rev. & Tax. Code § 23101, now Cal. Rev. & Tax. Code § 23101(a).

California Appellate Court Rules in "Doing Business" in California Case (cont.)

Insights

• By holding that a passive investor with a minority interest in a manager-managed LLC doing business in California cannot be deemed to be doing business in California, a Court of Appeal has rejected Legal Ruling 2014-01 and dispels the FTB's position that LLC interests are equivalent to general partnership interests. As the court did not establish a bright-line test regarding the point at which a minority interest holder's influence would be considered more than minimal, it would appear that the materiality of the influence exerted by minority interest holders (i.e., those with a greater than 0.2 percent but less than 50 percent interest) would require a factual analysis on a case-by-case basis. The FTB may file a petition for review by the California Supreme Court within 10 days after the Court of Appeal decision becomes final.

• Taxpayers with similar facts should consider filing protective refund claims pending an appeal.

• For tax years beginning on or after January 1, 2011, California changed its "doing business" definition and adopted an economic factor-presence nexus statute. The Court of Appeal's decision in Swart Enterprises leaves open the issue of whether a passive interest holder in a pass-through entity can be deemed to be "doing business" in California by virtue of its share of the pass-through entity's apportionment attributes.

• The court's emphasis on the active aspect of engaging in business transactions could also call into question other scenarios, such as whether an out-of-state company could be "doing business" in California if it drop ships goods into California at the request of its customers to an extent that the entity's sales exceeds California's sales threshold under the economic factor-presence nexus statute. Specifically, it is unclear whether such activity, which is outside of the entity's control, would be considered "actively" engaging in business transactions within the state.

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