taxnotes® state

Volume 96, Number 5 ■ May 4, 2020

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Reprinted from *Tax Notes State*, May 4, 2020, p.645

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Kathleen S. Cornett

Joshua A. Labat

Kathleen S. Cornett and Joshua A. Labat are associates at Alston & Bird LLP in Atlanta and New York, respectively.

In this installment of Audit & Beyond, the authors discuss a 2017 article by Clark Calhoun and how the issue of out-of-state members of limited liability companies doing business in California has evolved for franchise tax nexus purposes.

In the January 2017 roundtable series,[1] our colleague Clark Calhoun hypothesized that a dark horse issue of 2017 would be the extent to which states have nexus over nonresident partners or members. Noting that there had been some significant, if inconsistent, state court decisions on this topic in the past decade (New Jersey's *BIS*,[2] Ohio's *Corrigan v. Testa*,[3] and Kentucky's *Asworth Corp.*[4]), and expecting a decision from the Court of Appeal of California in *Swart Enterprises*,[5] Clark opined that it was increasingly important for taxpayers to argue — and for courts to uphold — that "the due process clause imposes some limitations on states' jurisdiction to impose tax on a specific taxpayer or transaction."

Unfortunately, Clark's crystal ball shouldn't have been trusted. Three years later, we do not appear to be any closer to a consistent approach among states on when due process limits them from imposing nexus on nonresident partners and members. For example, the Alabama Department of Revenue has ruled that a limited partnership interest does not constitute "doing business" in the state for franchise tax purposes.[6] But the Pennsylvania Supreme Court reached a different conclusion, holding that a nonresident investing in a limited partnership was liable for personal income tax on the gain that the partnership earned from the cancellation of debt.[7]

Clark was right, however, that the 2017 *Swart Enterprises* decision would set an important precedent for when out-of-state members of limited liability companies operating in California are themselves "doing business" in the state for franchise tax purposes. In 2019 the Office of Tax Appeals (OTA) issued two decisions applying the "fact-intensive inquiry" about the member's ownership and control over an LLC found in *Swart Enterprises*. The OTA ruled that nonresident members were not doing business in California for franchise tax purposes. Despite *Swart* and these OTA decisions, however, many unanswered

[1] *See* Clark R. Calhoun, "Board Sheds Light on Dark Horse Issues of 2017," *State Tax Notes*, Jan. 9, 2017, p. 99, at 100.

[2] *BIS LP Inc. v. Director, Division of Taxation*, 26 N.J. Tax 489 (N.J. App. Div. 2011).

[3] *Corrigan v. Testa*, 149 Ohio St. 3d 18 (2016).

[4] *Revenue Cabinet v. Asworth Corp.*, No. 2007-CA-002549-MR (Ky. Ct. App. 2009).

[5] *Swart Enterprises Inc. v. Franchise Tax Bd.*, 7 Cal. App. 5th 497 (Cal. Ct. App. 2017).

[6] Ala. Rev. Rul. 98-002 (Ala. Dep't of Rev. Jun. 16, 1998).

[7] *Wirth v. Commonwealth*, 626 Pa. 124 (2014).

questions and inconsistencies remain in California's determination of nexus for nonresident partners and members.

As a quick refresher, *Swart Enterprises* involved an Iowa corporation that operated a 60-acre farm in Kansas that acquired a 0.2 percent interest in Cypress LLC. Cypress LLC was a California LLC that had elected to be treated as a partnership for federal income tax purposes. The Court of Appeal rejected the Franchise Tax Board's position that Swart Enterprises was doing business in California for purposes of the corporation franchise tax based solely on its passive, minority ownership interest in an LLC doing business in the state. Cypress was manager-managed, and Swart had no authority to influence Cypress's management or the selection of the manager.

The court noted that the State Board of Equalization had "previously recognized a limited partner is not 'doing business' merely by virtue of its ownership interest in a limited partnership."[8] Comparing Swart to a limited partner in a partnership, the court held that "because the business activities of a partnership cannot be attributed to limited partners, Swart cannot be deemed to be 'doing business' in California solely by virtue of its ownership interest in Cypress."[9]

The *Swart Enterprises* decision helpfully established that a minimal passive ownership interest in an LLC operating in California, no matter how small, does not create nexus for a nonresident member under the franchise tax. But because the court held that Swart Enterprises was not doing business in California for purposes of section 23101(a) of the California Revenue and Taxation Code, the court did not reach the taxpayer's commerce clause or due process clause arguments.

As expected, the FTB was not deterred by *Swart Enterprises*. The board interpreted the decision as narrowly as possible and took the position that a 0.2 percent ownership interest was a bright-line threshold for actively doing business in California. The FTB considered any member of an LLC with a membership interest exceeding 0.2 percent doing business in California to also be doing business in the state.

Thankfully, the FTB's 0.2 percent threshold was relatively short-lived. In July 2019 the OTA rejected the FTB's tortured application of *Swart Enterprises* in *In the Matter of the Appeal of Jali LLC*.[10] Like Swart Enterprises, Jali's sole connection to California was its passive, minority interest (below 5 percent in each tax year) in an LLC, Bullseye Capital Real Property Opportunity Fund LLC, doing business in California. The OTA observed that Jali shared other similarities with Swart Enterprises, including that the LLC was manager-managed, that Jali was not personally liable for any of the LLC's debts or liabilities, had no interest in any specific property of the LLC, and had no authority to participate in management. The OTA concluded that:

> like Swart's interest in Cypress, [Jali's] interest in Bullseye closely resembles that of a limited, rather than a general, partner, and there is no evidence that [Jali] had any ability or authority, directly or indirectly, to influence or participate in the management or operation of Bullseye.[11]

The OTA explicitly "reject[ed] FTB's 0.2 percent ownership threshold as the new bright-line legal standard for distinguishing between an active and a passive ownership interest in an LLC classified as a partnership"; rather, "one must still generally conduct a fact-intensive inquiry into the relationship between the out-of-state member and the in-state LLC" to make a nexus determination.[12] The OTA gave *Jali* precedential status, establishing the "fact-intensive inquiry" into the nonresident member's relationship with the in-state LLC as *the* test for determining nexus for nonresident members for franchise tax purposes.[13]

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[8] *Swart Enterprises*, 7 Cal. App. 5th at 507 (citing *Appeals of Amman & Schmid Finanz AG*, 96-SBE-008 (Cal. Bd. of Equal. Apr. 11, 1996)).

[9] *Id.* at 503.

[10] OTA Case No. 18073414 (Cal. Off. Tax App. July 8, 2019).

[11] *Jali* at *5.

[12] *Id.*

[13] On February 24, 2020, the U.S. Supreme Court denied Arizona's motion to file a complaint, based on the Court's original jurisdiction, challenging California's imposition of this franchise tax on out-of-state businesses that invest in California LLCs. Arizona could still pursue litigation in other venues.

The OTA had an opportunity to apply this test again just a month later in *Appeal of Wright Capital Holdings LLC*.[14] Wright Capital was a disregarded, single-member LLC domiciled in Georgia and not registered to do business in California. Wright Capital held a 50 percent interest in an LLC, Collegiate Consulting LLC (CC-LLC), treated as a partnership for federal income tax purposes, that conducted business in California. While acknowledging that Wright Capital did not hold a controlling interest in the LLC, the OTA upheld the FTB's determination that Wright Capital was doing business in California by virtue of its 50 percent ownership interest in the LLC because Wright Capital failed to satisfy "its burden of proving that it lacked the power or authority, directly or indirectly, to participate in CC-LLC's management or operations."[15] Wright Capital did not present any evidence to the OTA concerning whether CC-LLC was member-managed or manager-managed or whether Wright Capital had the power to direct and control CC-LLC under the organizational documents.

We do not know if the OTA would have ruled differently if Wright Capital had provided evidence demonstrating both that CC-LLC was manager-managed and that Wright Capital lacked any control of CC-LLC. A 50 percent ownership interest in an LLC is a far cry from the 0.2 percent and less than 5 percent ownership interests at issue in *Swart Enterprises* and *Jali*, respectively, but the OTA's decision clarifies that ownership percentage alone does not determine nexus: A taxpayer must also establish its characteristics as a limited partner. On the other end of the ownership spectrum, in *Bunzl Distribution USA Inc. v. Franchise Tax Board*,[16] the Court of Appeal had held that substantial nexus existed for the single member of a disregarded LLC when the disregarded LLC conducted significant business in California.

Just as Clark hoped, *Swart Enterprises*, *Jali*, and *Wright Capital* added needed clarity (and sanity) to California's nexus standards for nonresident partners and members. But the court's refusal to address the constitutional nexus issues means the reach of *Swart Enterprises* is unlikely to extend meaningfully beyond California, or even to apply to other nexus issues under California law.

In another 2019 decision, albeit nonprecedential, *Appeal of LCP VII Holdings LP*,[17] the OTA limited *Swart Enterprises* only to questions of whether an LLC was "doing business" in California within the meaning of subsection (a) of section 23101 of the California Revenue and Tax Code.

Section 23101 defines doing business for purposes of the corporation franchise tax. Subsection (a) defines doing business as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." The Court of Appeal had held in *Swart Enterprises* that the nonresident member was not "actively" doing business under section 23101(a) based solely on its 0.2 percent ownership interest in the California LLC.

LCP VII Holdings argued, based on *Swart Enterprises*, that it was not doing business in California because its only connection to California was as a limited partner of passthrough entities that did business in the state. The OTA held that *Swart Enterprises* did not apply because LCP VII Holdings was doing business based on the factor presence nexus standards in subsection (b) of section 23101 of the California Revenue and Tax Code: LCP VII Holdings' gross receipts from passthrough entities sourced to California exceeded the factor presence thresholds in section 23101(b)(2).[18] According to the OTA, *Swart Enterprises* applied only to questions whether a taxpayer was actively doing business for purposes of subsection (a); under that reasoning and holding, if the taxpayer meets the doing business standard based on any of the factor presence standards in subsection (b), then there is no need to engage in a "fact-intensive inquiry" regarding the relationship between the taxpayer and the LLC operating in California.

[14] OTA Case No. 18010842 (Cal. Tax App. Aug. 21, 2019).

[15] *Wright Capital* at *5.

[16] 27 Cal. App. 5th 986, 998 (2018).

[17] OTA Case No. 18042958 (Cal. Tax App. Nov. 20, 2019).

[18] Cal. Rev. & Tax. Code section 23101(d) states that "the sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of pass-through entities. For purposes of this subdivision, 'pass-through entities' means a partnership or an 'S' corporation."

It is encouraging that the OTA has applied a reasonable interpretation of *Swart Enterprises*, rather than accepting the FTB's narrow 0.2 percent bright-line ownership threshold. But the scope of *Swart Enterprises* appears narrowed after *LCP VII Holdings*. One can imagine a nonresident member of a large, manager-managed LLC whose passthrough gross receipts sourced to California exceed $500,000, and thus has factor presence nexus under section 23101(b)(2); however, the nonresident member owns less than a 5 percent interest in the LLC and has no authority to direct or control the LLC. Yet based on *LCP VII Holdings*, the fact-intensive inquiry into the relationship between the member and the LLC applied in *Swart Enterprises* and *Jali* is irrelevant to determining whether this member has nexus.

The narrowing of the application of *Swart Enterprises* in *LCP VII Holdings* also indicates that it is unlikely that the OTA will apply the principles of *Swart Enterprises* to determine nexus for a nonresident member in other scenarios, such as determining when an individual member has nexus for personal income tax purposes. ■