OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18073414
	)	
JALI, LLC	)	Date Issued: July 8, 2019
	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellant: James Buckley, Manager

For Respondent: Leah Thyberg, Tax Counsel

For Office of Tax Appeals: Andrea Long, Tax Counsel

K. GAST, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19324, Jali, LLC (appellant) appeals an action by respondent Franchise Tax Board (FTB) denying appellant's claim for refund of $1,445.25, $863, $800, $864, and $870, for the 2012, 2013, 2014, 2015, and 2016 tax years, respectively.[1] Appellant waived its right to an oral hearing. Therefore, this matter is being decided based on the written record.

ISSUE

Was appellant doing business in California under R&TC section 23101(a) and therefore subject to the annual $800 LLC tax?

FACTUAL FINDINGS

1. Appellant is a foreign LLC formed in Washington State. For the years at issue, it was not registered to do business with the California Secretary of State (SOS).

[1] The refund amounts at issue consist of the annual $800 limited liability company (LLC) tax, and for all years except for 2014, penalties and interest. The record, however, does not reveal what penalties were imposed or the breakout of the amounts related to penalties and interest. Because we grant appellant's refund claim in full, this omitted information is irrelevant.

2. In December 2012, appellant acquired an ownership interest in Bullseye Capital Real Property Opportunity Fund, LLC (Bullseye). Bullseye is a foreign LLC formed in Delaware on April 22, 2010.[2] It is classified as a partnership for income tax purposes, registered with the California SOS, and conducted business in California for all disputed years.
3. Bullseye's operating agreement, effective November 5, 2010, states that "[t]he purpose of [Bullseye] is to acquire, improve, own, manage, sell, dispose of and otherwise realize on the value of the [real property or properties] and to engage in all transactions reasonably necessary or incidental to the foregoing…."
4. Appellant owned a direct, capital interest in Bullseye of 4.75 percent and 3.19 percent for the 2012 and 2013 tax years, respectively, and 1.12 percent for the 2014, 2015, and 2016 tax years. Appellant's membership interest was its sole connection with California.
5. Appellant did not initially file a California LLC return (i.e., Form 568) for any tax year. Based on California Schedule K-1s issued by Bullseye to appellant showing its capital interest percentage in Bullseye, FTB determined appellant had a filing obligation.[3] FTB issued a Demand for Tax Return for the 2012 tax year. Appellant filed a 2012 return, and subsequently filed 2013 through 2016 tax returns.
6. After paying taxes, penalties, and interest, appellant filed refund claims for all amounts paid on the basis that it was not doing business in California. FTB denied the claims, asserting appellant did not meet the facts of *Swart Enterprises, Inc. v. Franchise TaxBd.* (2017) 7 Cal.App.5th 497 (*Swart*). This timely appealfollowed.

DISCUSSION

Appellant bears the burden of proving entitlement to its refund claim, which means it must not only prove the tax paid was incorrect, but must also produce evidence to establish the

[2] Bullseye is a "series" LLC. In general, a series LLC is a form of LLC that allows certain assets and liabilities to be segregated, as if contained in a separate corporate-like subsidiary of the LLC. (See Jelsma, *State Taxation of Limited Liability Companies and Partnerships*, 1560-2nd Tax Management Portfolio (BNA), 1560.04(J).) In most cases, the debts, liabilities, and obligations incurred, contracted for, or otherwise existing with respect to a particular series are enforceable against the assets of only that series, and not against the assets of the LLC generally or any other series of the LLC. (*Ibid*.) Here, neither party contends—and we do not find—that this form of LLC is relevant in resolving the issue in this appeal. We simply note this fact for completeness purposes.

[3] FTB provided incomplete copies of the 2012 through 2016 Schedule K-1s that showed no indication of California source income or a requirement to file a Form 565.

proper amount of tax due, if any. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235.) For reasons discussed below, we find appellant has met its burden.

R&TC section 17941(a) provides that an LLC "doing business" in California, as defined in R&TC section 23101, shall pay the annual $800 LLC tax. R&TC section 23101, in turn, establishes two alternative ways a taxpayer is considered doing business in California. FTB bases its assessment in this case on R&TC section 23101(a), which provides that a taxpayer is doing business in California if it is "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."[4]

On appeal, both parties rely on *Swart, supra,* to support their positions. In that case, the issue was whether the California corporate franchise tax applied to an out-of-state corporation (Swart) whose sole connection with the state was a passive 0.2 percent ownership interest in a manager-managed (as opposed to member-managed) California LLC (Cypress). (*Swart*, *supra*, 7 Cal.App.5th at p. 500.) FTB argued that Swart, who was not the designated manager of Cypress, was deemed to be doing business in California solely because it owned an interest in Cypress, which had elected to be classified as a partnership for tax purposes and was doing business in California. (*Id*. at p. 502.) The court rejected this position, and sided with the taxpayer. It held that passively holding a 0.2 percent ownership interest, with no right of control over the business affairs of Cypress, did not constitute doing business in California within the meaning of what is now R&TC section 23101(a). (*Id*. at p. 500.)

FTB seeks to distinguish the facts in *Swart* from those here. In doing so, it places heavy, if not sole, reliance on one statement made by the *Swart* court: "We conclude Swart was not doing business in California based solely on its minority ownership interest in Cypress LLC." (*Swart*, *supra*, 7 Cal.App.5th at p. 513.) FTB seizes upon this language and argues that "[b]ecause 'solely' means 'exclusively,' that means actively doing business is exclusively dependent on the size of a taxpayer's membership interest, i.e., the size of a business entity's membership interest is not only suggestive of *doing business*, but dispositive." (Emphasis in original.) FTB then concludes that "[b]ecause the membership interest in *Swart* was 0.2%, 0.2%

[4] The second way a taxpayer is considered doing business in California is if it satisfies certain bright-line nexus conditions or thresholds found in R&TC section 23101(b)(1) through (4), which is effective for tax years beginning on or after January 1, 2011. Because FTB does not assert—and the limited record does not show—any of these conditions or thresholds are satisfied in this appeal, we do not consider them further.

is deemed to be the threshold between *actively* doing business and *passively* doing business moving forward." (Emphasis in original.)

FTB thus takes the position that a 0.2 percent membership interest in an LLC doing business in California is the new, post-*Swart* bright-line ownership threshold used to determine whether an out-of-state member is also doing business in the state. As applied to the facts of this appeal, FTB concludes that appellant is deemed to be "actively" doing business in California because its membership interest in Bullseye "was well beyond the 0.2% *Swart* limit." We disagree.

FTB misconstrues the *Swart* court's statement, "We conclude Swart was not doing business in California based solely on its minority ownership interest in Cypress LLC." The court's opinion was not "based solely" on Swart's minority ownership interest. Rather, in making this statement, the court was simply dismissing FTB's argument that the court should base its decision on that fact alone. When the entire opinion is considered, it becomes abundantly clear the court's holding was squarely grounded on the relationship between the out-of-state member and the in-state LLC.

Thus, the court pointed to the fact that "Swart had no interest in the specific property of Cypress LLC, it was not personally liable for the obligations of Cypress LLC, it had no right to act on behalf of or to bind Cypress LLC and, most importantly, it had no ability to participate in the management and control of Cypress LLC." (*Swart, supra*, 7 Cal.App.5th at pp. 503, 508, 510-511.) In the court's view, these facts demonstrated that Swart's interest closely resembled that of a limited, rather than a general, partner. (*Id.* at p. 503.) Indeed, in rejecting the same argument FTB advanced there as it does here, the court concluded that "[b]ecause 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 LLC." (*Ibid.*, emphasis added and internal citation omitted.)[5] Accordingly, *Swart* did not establish a bright-line 0.2 percent ownership threshold for purposes of making nexus determinations for out-of-state members holding interests in in-state LLCs classified as partnerships.

[5] Later in the opinion, the court also noted that "Swart contends that like a limited partner, it was merely a passive investor, and it had no right to manage or control the business operations of Cypress LLC. On this basis, it asserts it cannot be deemed to be 'doing business' in California *solely by virtue of holding a membership interest in an LLC doing business in California. We agree.*" (*Swart, supra*, 7 Cal.App.5th at p. 509, emphasis added.)

Employing the foregoing legal analysis from *Swart*, we agree with appellant that it is not subject to California tax. Appellant points to certain relevant facts—none of which FTB contests—that are virtually identical to those in *Swart*. Under its operating agreement, (1) Bullseye is a manager-managed LLC,[6] (2) it is managed by an elected director(s), not appellant,[7] (3) appellant is not personally liable for any debt, obligation, or liability of Bullseye, (4) appellant has no power to participate in Bullseye's management, or bind or act on behalf of it in any way, and (5) appellant has no interest in any specific property of Bullseye.[8] And, even though appellant's percentage interest in Bullseye is greater than that in *Swart* (between 1.12 to 4.75 percent versus 0.2 percent), both are undisputedly minority interests. Therefore, like Swart's interest in Cypress, appellant's interest in Bullseye closely resembles that of a limited, rather than a general, partner, and there is no evidence that appellant had any ability or authority, directly or indirectly, to influence or participate in the management or operation of Bullseye.

In short, we reject 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. While ownership percentages may be a factor in nexus determinations, it is not necessarily dispositive,[9] as one must still generally conduct a fact-intensive inquiry into the relationship between the out-of-state member and the in-state LLC. This may include whether the in-state LLC is manager-managed, whether the out-of-state member holds a non-managing member interest, and whether the out-of-state member is actively

[6] The court found it relevant that Swart could not "have exercised any right of control by relinquishing control of Cypress LLC to a manager, because it never had this right to begin with." (*Swart*, *supra*, 7 Cal.App.5that p. 512.) This was because the designation to make Cypress LLC a manager-managed LLC occurredtwoyears *before* Swart made its investment in Cypress LLC. (*Ibid*.) The same is true here; i.e., appellant acquired its ownership interest in Bullseye two years after it was formed, and therefore could not have participated in the original decision to make Bullseye a manager-managed LLC.

[7] Appellant asserts that while the directors are elected by members, it has never exercised this vote or been given the opportunity to exercise such a vote. Although appellant does not provide support for this factual assertion, FTB does not contest it and we have no reason to question it.

[8] See Bullseye's Operating Agreement, §§ 1.22, 1.31, 4.1, 4.8, 5.1, 5.3, & 15.16.

[9] In the recent case of *Bunzl Distribution USA, Inc. v. Franchise Tax Bd.* (2018) 27 Cal.App.5th 986, 997-998, the court distinguished *Swart* and concluded the taxpayer's 100 percent ownership interest in an in-state LLC that was disregarded as separate from its single-member owner for tax purposes did create substantial nexus for the out-of-state single-member. However, here and in *Swart*, the in-state LLCs are not wholly-owned but rather are partnerships for tax purposes, and the members do not hold controlling interests.

involved in the business activities of the in-state LLC. We believe such an interpretation properly reflects the rationale of *Swart* and faithfully adheres to its legal principles.

HOLDING

Appellant has met its burden of showing it was not doing business in California under R&TC section 23101(a) and therefore is not subject to the annual $800 LLC tax.

DISPOSITION

FTB's action denying appellant's refund claim is reversed in full. Accordingly, appellant is due a refund of all taxes, penalties, and interest paid, plus applicable interest.

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Kenneth Gast
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Administrative Law Judge

We concur:

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