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2020 – OTA – 255P
Pending Precedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19074982
AROYA INVESTMENT I, LLC	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Stuart Bender, CPA

For Respondent: Louis A. Ambrose, Tax Counsel IV

For Office of Tax Appeals: William J. Stafford, Tax Counsel III

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Aroya Investment I, LLC (appellant) appeals an action by respondent Franchise Tax Board (FTB) denying its claim for refund of the annual $800 limited liability company (LLC) tax for the 2016 tax year.[1] Appellant waived its right to an oral hearing, and therefore this matter is being decided based on the written record.

ISSUE

Whether appellant was doing business in California and, therefore, subject to the $800 LLC tax.

[1] Appellant's appeal letter also disputed an annual $800 LLC tax FTB proposed for appellant's 2017 tax year. However, the Office of Tax Appeals (OTA) notified the parties it was not taking jurisdiction over that year because FTB informed OTA that it had not yet issued a notice of action or denial of a claim for refund for 2017. Appellant does not appear to disagree; its reply brief lists 2016 as the only tax year at issue, although it frames the issue on appeal as whether it was doing business in California for "all years [after 2016] in which the same set of facts apply." Thus, our opinion only concerns the 2016 tax year and we decline to issue an advisory opinion on subsequent years not properly before us. (See Cal. Code Regs., tit. 18, § 30103(a) [limiting OTA's jurisdiction to, among other things, appeals of an FTB notice of action on a proposed deficiency assessment or denial of arefund claim].)

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FACTUAL FINDINGS

1. Appellant is an LLC that is classified as a partnership for both federal and California income tax purposes. It is a foreign LLC formed in Delaware in 2007 and based in New York. Appellant was not registered to do business with the California Secretary of State for 2016.
2. In December 2014, appellant acquired a minority, non-managing membership interest in 1155 Island Avenue, LLC (Island). Island is a board-managed LLC formed in Delaware on August 18, 2014. It is classified as a partnership for both federal and California income tax purposes. It conducted business in California within the meaning of R&TC section 23101 during 2016.
3. Island's LLC agreement, effective December 11, 2014, provides that the purpose of Island is to, among other things, own, operate, lease, finance, sell, and manage a facility on property that it had acquired from the Thomas Jefferson School of Law in San Diego, California (the Property).[2]
4. According to San Diego County real property tax assessment records for the 2016-2017 and 2017-2018 fiscal years, Island was the Property's owner of record throughout 2016.[3] These records indicate the total assessed value of the Property (both land and improvements) was $64,239,943 and $65,524,741 as of January 1, 2016 and 2017, respectively.
5. For the 2016 tax year, appellant owned a direct profit, loss, and capital interest in Island, consisting of a beginning and ending year percentage of 0.7830849. Appellant's membership interest in Island was its sole connection with California during 2016.

[2] It appears the law school conveyed the Property to Island pursuant to a deed in lieu of foreclosure, and Island held no assets or liabilities as of its formation date. (Island LLC Agreement, §§ 2.4, 3.1(c).)

[3] California real property tax is imposed on a fiscal year basis, with the fiscal year beginning July 1 and ending June 30. (R&TC, § 75.6.) The real property's value for property tax purposes, however, is determined as of the "lien date," that is, the January 1 date that precedes the beginning of the fiscal year. (R&TC, § 2192.)

6. Appellant timely filed a 2016 California LLC return (Form 565) and paid the $800 LLC tax.[4] It then filed an amended return, seeking a refund of the $800 on the basis that it was a limited partner of Island and was not doing business in California.
7. FTB denied the claim, asserting that "[n]onregistered foreign LLCs [such as appellant] that are members of an LLC doing business in California [such as Island] are considered to be doing business in California." This timely appeal followed.

DISCUSSION

Appellant bears burden of proving entitlement to its refund claim. (*Appeal of Jali, LLC*, 2019-OTA-204P (*Jali*).) For reasons discussed below, we find appellant has not 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. Under R&TC section 23101(b), a taxpayer is considered doing business in California if it satisfies certain bright-line nexus thresholds consisting of sales, property, or payroll amounts. FTB bases its refund claim denial on the property threshold in R&TC section 23101(b)(3), which provides in relevant part:

> (b) For taxable years beginning on or after January 1, 2011, a taxpayer is doing business in this state for a taxable year if any of the following conditions has been satisfied:
>
> ***
>
>> (3) The real property and tangible personal property of the taxpayer in this state exceed the lesser of fifty thousand dollars ($50,000) or 25 percent of the taxpayer's total real property and tangible personal property. The value of real and tangible personal property and the determination of whether property is in this state shall be determined using the rules contained in Sections 25129 to 25131, inclusive, and the regulations thereunder, as modified by regulation under Section 25137.[5]

FTB notes that in determining whether appellant has exceeded the California property threshold amount, one must take into account appellant's pro rata share of California property

[4] Appellant's 2016 California Schedule K-1 from Island shows that appellant had a distributive share of net loss from rental real estate activities of approximately $28,000 and interest income of approximately $7,000. Island left Table 2 of Schedule K-1 blank, omitting information as to appellant's share of Island's California and everywhere property, payroll, and sales factor apportionment data.

[5] The $50,000 amount is adjusted for inflation each year. (R&TC, § 23101(c).) For the 2016 tax year, the amount was $54,771. (See <https://www.ftb.ca.gov/file/business/doing-business-in-california.html> [accessed June 11, 2020].)

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owned by pass-through entities in which appellant held an interest (here, Island), pursuant to R&TC 23101(d), which provides as follows:

> (d) 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 . . . .

FTB contends appellant's distributive share of Island's Property, situated in California, exceeds $54,771, and therefore appellant was doing business in the state in 2016 and subject to the $800 LLC tax. Although the evidence in the record is somewhat limited, that evidence, together with the reasonable inferences that may be derived therefrom, are sufficient to support FTB's determination.

For purposes of applying the property factor threshold, property owned "is valued at its original cost." (R&TC, §§ 23101(b)(3), 25130.) "As a general rule 'original cost' is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto . . . ." (Cal. Code Regs., tit. 18, § 25130(a)(1).) We initially note FTB's threshold analysis is incorrect because it relies on assessed value, as opposed to cost. However, we believe, in the absence of contrary information, that FTB's evidence, and the inferences that reasonably may be drawn therefrom, are sufficient to support FTB's determination that appellant's pro rata share of Island's California Property likely exceeded the applicable threshold of $54,771.

According to Island's LLC agreement, it acquired the Property, via a deed in lieu of foreclosure, no earlier than its formation in 2014. We know that the Property's assessed value in 2016 and 2017 was approximately $64 million. To determine the likely price at which the property was transferred to Island approximately two years earlier, we discount the 2016-2017 assessed value of $64 million to $61.5 million (to take into account two years of potential 2 percent assessed value increases under Proposition 13), and conclude that this amount roughly approximates Island's original cost for the Property, as well as its value for purposes of R&TC sections 23101(b)(3) and 25130. (See Cal. Code Regs., tit. 18, § 25130(a) ["If original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer"].) Thus, a fair conclusion can be drawn that appellant's pro

rata share of Island's California Property was approximately $481,000 (0.7830849 percent times $61.5 million), which significantly exceeds the applicable threshold of $54,771.[6]

Indeed, appellant does not dispute the conclusion that it had California property exceeding $54,771 within the meaning of R&TC section 23101(b)(3).[7] Rather, it contends it was not "doing business" in California under R&TC section 23101(a) and *Swart Enterprises, Inc. v. Franchise Tax Bd.* (2017) 7 Cal.App.5th 497 (*Swart*). R&TC section 23101(a) defines "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." Interpreting what is now designated as subdivision (a) of R&TC section 23101, *Swart* held that an out-of-state corporation's passive holding of a 0.2 percent ownership interest in a manager-managed LLC that was doing business in California, with no right of control over the business affairs of that LLC, was not itself doing business in California. (*Swart, supra,* 7 Cal.App.5th at p. 500; see also *Jali, supra* [to the same effect].)

Appellant's contention that *Swart* requires us to hold in its favor is incorrect for three reasons. First, for taxable years beginning on or after January 1, 2011, subdivisions (a) and (b) of R&TC section 23101 contain two alternative tests for doing business, and the satisfaction of *either test* leads to a nexus finding. (*Appeal of GEF Operating, Inc*., 2020-OTA-057P (*GEF Operating*); see also *Swart*, *supra*, 7 Cal.App.5th at p. 503, fn. 2). Since, as discussed above, appellant does not dispute its property exceeded the bright-line threshold amount under R&TC section 23101(b)(3), it is doing business in California and that ends the inquiry. Therefore, a duplicative analysis under subdivision (a) is unnecessary.

Second, appellant mistakenly asserts *Swart* considered and dismissed a similar argument to the one FTB advances here. *Swart* dealt with a tax year *prior to* 2011, and the court specifically recognized the significance of this by noting the following in footnote 2 of its opinion: "For tax years beginning on or after January 1, 2011, a taxpayer is *also* 'doing business' in California if the taxpayer is organized or commercially domiciled in California, *or* a

[6] The plain language of R&TC section 23101(b)(3) appears to only look to the "value" of the real or tangible property, even though it references R&TC section 25131, which for property factor computations, uses "average value" that is "determined by averaging the values at the beginning and ending of the taxable year." But we need not decide which valuation method to use because under either scenario, appellant's distributive share of property still exceeds $54,771.

[7] In its reply brief, appellant states "[it] believes [FTB] has accurately represented the facts in [FTB's] opening brief," and "[u]pon review of [FTB's] opening brief, there are no material facts in dispute."

taxpayer's California sales, property, or payroll exceed the amounts applicable under subdivision (b)(1) of section 23101. *Because the franchise tax was imposed for Swart's tax year ending June 30, 2010, these new bases for 'doing business' do not apply to Swart*." (*Swart, supra,* 7 Cal.App.5th at p. 503, fn. 2, italics added.) Therefore, even assuming, without deciding, that appellant's facts fall squarely within those of *Swart*, it is nonetheless considered doing business in California by satisfaction of R&TC section 23101(b)(3).[8]

Lastly, for purposes of applying the bright-line tests, the plain language of R&TC section 23101(d) itself makes no distinction between active versus passive ownership interests, or general versus limited partnerships: "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 . . . ."[9] In fact, given the addition of subdivisions (b) and (d) to R&TC section 23101, "the language of the changes made and the legislative history suggest that the purpose of those revisions was to broaden the scope of 'doing business' to explicitly encompass owners of pass-through entities with economic presence in California." (*GEF Operating, supra*, at p. 8.) Thus, appellant was doing business in California.

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[8] As further support, appellant cites to our nonprecedential opinion in *Appeal of Satview Broadband, Ltd.*, 2018-OTA-121. However, since that opinion is nonprecedential, it cannot be relied upon by the parties or OTA in an appeal. (Cal. Code Regs., tit. 18, § 30502(b).) In any event, for reasons just explained, *Satview* is consistent with our opinion because FTB never alleged in *Satview*, as it does here, that any of the bright-line thresholds under R&TC section 23101(b) had been satisfied. The opinion turned on whether appellant had nexus under the alternative nexus test of R&TC section 23101(a). For similar reasons, our precedential opinions in *Jali, supra*, and *Appeal of Wright Capital Holdings LLC*, 2019-OTA-219P, are also consistent with our opinion today because in those appeals FTB never asserted the bright-line tests were satisfied. Those appeals were resolved under R&TC section 23101(a).

[9] Appellant does not claim that its pro rata or distributive share from pass-through entities should exclude the Property. In this regard, we note that R&TC section 23101(d) requires that *all* pro rata and distributive share amounts should be taken into account; it does not limit such amounts to those flowing from entities engaged in a unitary business with the taxpayer.

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HOLDING

Appellant was doing business in California and subject to the $800 LLC tax.

DISPOSITION

FTB's action denying appellant's refund claim is sustained.

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

DocuSigned by:
Huy "Mike" Le
A11783ADD49442B...
Huy "Mike" Le
Administrative Law Judge

Date Issued: 7/7/2020