

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:) OTA Case Nos. 18083638, 19014240
LA HOTEL INVESTMENTS #3, LLC AND)
LA HOTEL INVESTMENTS #2, LLC)
_____)

OPINION

Representing the Parties:

For Appellants: George W. Griggs, CPA

For Respondent: Leah Thyberg, Tax Counsel III

For Office of Tax Appeals: Oliver Pfof, Tax Counsel

H. LE, Administrative Law Judge: These consolidated appeals are made pursuant to Revenue and Taxation Code (R&TC) section 19324. Franchise Tax Board (respondent) denied appellant LA Hotel Investments #3, LLC’s (Hotel #3) claim for refund of \$800 for the 2013 tax year, and denied appellant LA Hotel Investments #2, LLC’s (Hotel #2) claims for refund totaling \$2,400 for the 2013, 2014, and 2015 tax years.

Hotel #3 and Hotel #2 (collectively, appellants) waived their right to an oral hearing; therefore, we decide this matter based on the written record.

ISSUE

Whether appellants established that they were not doing business in California under R&TC section 23101 and, therefore, not subject to the annual \$800 limited liability company (LLC) tax.

FACTUAL FINDINGS

1. Appellants are LLCs organized in the state of Louisiana. For the tax years at issue, appellants were not registered to do business with the California Secretary of State.

Hotel #3

2. Hotel #3 was organized to invest in Irvine Center Hotels, LLC (Irvine Center), a California LLC that conducted business in California in 2013.
3. Irvine Center filed a California LLC Return of Income (Form 568) for the 2013 tax year. On its Schedule L-Balance Sheets, Irvine Center reported no buildings and other depreciable assets at the beginning of the tax year, and \$25,349,626 of buildings and other depreciable assets at the end of the tax year.¹
4. Irvine Center issued Hotel #3 a Federal Form 1065 Schedule K-1 for the 2013 tax year. This Schedule K-1 reports Hotel #3 had a 5.41 percentage interest (profit, loss and capital) in Irvine Center.
5. Hotel #3 untimely paid the annual \$800 LLC tax for the 2013 tax year.²

Hotel #2

6. Hotel #2 was organized to invest in Tustin Gateway SPE, LLC (Tustin Gateway), a California LLC that conducted business in California in 2013, 2014, and 2015.
7. Tustin Gateway filed Forms 568 for the 2013, 2014, and 2015 tax years.
8. On its 2013 California return, Schedule L-Balance Sheets, Tustin Gateway reported no buildings, no other depreciable assets, and no land at the beginning of the tax year. At the end of the tax year, Tustin Gateway reported buildings and other depreciable assets of \$41,685,346 (prior to depreciation) and land of \$9,262,328.³
9. On its 2014 California return, Schedule L-Balance Sheets, Tustin Gateway reported buildings and other depreciable assets of \$42,172,143 (prior to depreciation) and land of \$9,262,328 at the end of the year. On its 2015 California return, Schedule L-Balance Sheets, Tustin Gateway reported these same amounts for the beginning of the tax year but zero amounts for the end of the tax year.

¹ This evidence shows that properties were placed in Irvine Center in 2013. There is no evidence or argument to the contrary.

² The untimeliness of this payment, and the associated penalties and interest, are not at issue in this appeal.

³ This evidence shows that properties were placed in Tustin Gateway in 2013. There is no evidence or argument to the contrary.

10. Tustin Gateway issued Hotel #2 California Schedule K-1s (568) for the 2013, 2014, and 2015 tax years. The 2013 Schedule K-1 reports Hotel #2 had a 2.56 percentage interest in Tustin Gateway, and the 2014 and 2015 Schedules K-1 reported a 5.13 percentage interest in Tustin Gateway.⁴
11. Hotel #2 timely paid the annual \$800 LLC tax for the 2013, 2014, and 2015 tax years.

Procedural History

12. Hotel #3 filed a refund claim for the annual \$800 LLC tax it paid for the 2013 tax year. Hotel #2 filed refund claims for the annual \$800 LLC tax it paid for the 2013, 2014, and 2015 tax years. Appellants stated they were not doing business in California in those tax years and, therefore, not subject to the annual \$800 LLC tax.
13. Respondent denied appellants' claims for refund. These timely consolidated appeals followed.

DISCUSSION

An LLC doing business in California must pay an annual \$800 LLC tax for the privilege of doing business in this state. (R&TC, §§ 17941(a), 23153(d)(1).) 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.) Under R&TC section 23101(a), 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.” Under R&TC section 23101(b), a taxpayer is doing business in California if it satisfies certain bright-line nexus thresholds consisting of sales, property, or payroll amounts. To receive a refund of their annual \$800 LLC tax, appellants must prove they were not doing business in California under R&TC section 23101. Appellants bear the burden of proving entitlement to their refund claims. (*Appeal of Aroya Investment I, LLC*, 2020-OTA-255P.) The applicable burden of proof standard is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).)

⁴ In this sentence, we refer to the member's percentage of profit sharing. We note that using the member's percentage of loss sharing or ownership of capital would have the same result under the facts of this appeal; thus, we need not make a finding in this appeal which of profit sharing, loss sharing, or ownership of capital should be used for purposes of R&TC section 23101(d).

Appellants argue they were not doing business in California under R&TC section 23101(a). Appellants pursued their refund claims based on the decision reached in *Swart Enterprises, Inc. v. Franchise Tax Bd.* (2017) 7 Cal.App.5th 497 (*Swart*). *Swart* held that an out-of-state corporation's passive holding of a 0.2 percent ownership interest in a manager-managed LLC doing business in California, with no right of control over the business affairs of the California LLC, was not itself doing business in California under what is now R&TC section 23101(a). (*Id.* at p. 512-513.)

Respondent denied appellants' refund claims because it determined appellants were doing business in California under R&TC section 23101(a), stating appellants did not meet one or more of the facts of the *Swart* decision. On appeal, however, respondent argues appellants were doing business in California because appellants' respective distributive share of the real and tangible property of Tustin Gateway and Irvine Center exceeded the bright-line property threshold found in R&TC section 23101(b)(3).

Under R&TC section 23101(b)(3), an LLC is doing business in California if the value of its real and tangible personal property in California exceeds the lesser of \$50,000 or 25 percent of the taxpayer's total real property and tangible personal property. Respondent annually adjusts the \$50,000 amount for inflation. (R&TC, § 23101(c).) In 2013, the amount remained \$50,000, but in 2014 the amount was increased to \$52,956, and in 2015 it was further increased to \$53,644. The property of the taxpayer includes its pro rata or distributive share of pass-through entities. (R&TC, § 23101(d); *Appeal of Aroya Investment I, LLC, supra.*)

Real and tangible personal property owned is valued at its original cost. (R&TC, § 25130.) Generally, "original cost" is 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 and partial disposition thereof, by reason of sale, exchange, abandonment, etc. (Cal. Code Regs., tit. 18, § 25130(a)(1).)

Where the 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. (Cal. Code Regs., tit. 18, § 25130(a)(1).) Absent contrary evidence, balance sheets attached to a tax return contain entries that are a reasonable indicator of the fair market value of property when prepared relatively close in time to when the property was placed in the partnership, were made long before the value of the property was in issue and were not made in anticipation of litigation.

(*Graham v. Commissioner*, T.C. Memo. 2005-68.) The amounts reported on a return's Schedule L-Balance Sheet should agree with the books and records of the LLC.

In 2013, properties were placed in Irvine Center, and Irvine Center reported on its balance sheet buildings and other depreciable assets in California of \$25,349,626, the amount of which is, absent contrary evidence, a reasonable indicator of the fair market value since the balance sheet was prepared for the same year in which properties were placed in Irvine Center, and we have no evidence of the value of the property being in dispute at the time the balance sheet was prepared.⁵ Hotel #3 had a 5.41 percentage interest in Irvine Center in 2013. Therefore, Hotel #3's distributive share of Irvine Center's property in 2013 was \$1,371,415.⁶ Thus, we find Hotel #3's distributive share of Irvine Center's property in California for tax year 2013 exceeded the \$50,000 threshold⁷ to constitute doing business under R&TC section 23101(b)(3).

In 2013, properties were placed in Tustin Gateway, and Tustin Gateway reported on its balance sheet buildings and other depreciable assets and land in California totaling \$50,947,674. In 2014 and 2015, Tustin Gateway reported on its balance sheets, buildings and other depreciable assets and land in California totaling \$51,434,471. These amounts, just like with the amounts for the Irvine Center, are reasonable indicators of the fair market value of the property absent contrary evidence. Hotel #2 had a 2.56 percentage interest in Tustin Gateway in 2013, and a 5.13 percentage interest in 2014 and 2015. Therefore, Hotel #2's distributive share of Tustin Gateway's property in 2013 was \$1,304,260, and in 2014 and 2015, \$2,638,588. Thus, Hotel #2's distributive share of Tustin Gateway's property in California for tax years 2013, 2014, and

⁵ Appellants do not dispute that Irvine Center and Tustin Gateway owned properties in California and made no arguments that some or all of the properties reported on Irvine Center and Tustin Gateway balance sheets are located outside of California.

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, appellants' distributive share of property still exceeds the applicable threshold for the years at issue. Furthermore, appellants made no arguments regarding the value of property and the determination of whether property is in California as determined under the rules contained in R&TC sections 25129 to 25131, inclusive, and the regulations thereunder, as modified by regulation under R&TC section 25137.

⁷ We reference the \$50,000 threshold since \$50,000 is less than 25 percent of Hotel #3's total real property and tangible personal property.

2015 exceeded the \$50,000 threshold, adjusted for inflation, to constitute doing business in California under R&TC section 23101(b)(3).

Indeed, appellants do not dispute respondent's calculation of the amount of California property appellants must include in their respective distributive shares for purposes of R&TC section 23101(b)(3). Instead, appellants argue they were not doing business in California in the tax years at issue within the meaning of R&TC section 23101(b) because *Swart* did not address R&TC section 23101(b) and it seems a "stretch" to try to allocate a prorated percentage of income and assets to passive investors. We note that the dispute in *Swart* concerned a tax year before enactment of R&TC section 23101(b), and therefore R&TC section 23101(b) did not apply to the taxpayer in *Swart*. Appellants are, however, subject to R&TC section 23101(b) because they were members in Tustin Gateway and Irvine Center, respectively, after R&TC section 23101(b) went into effect for tax years 2011 and forward.

Based on appellants' respective distributive shares of property in Tustin Gateway and Irvine Center, we find appellants were doing business within the meaning of R&TC section 23101(b)(3) for the tax years at issue, and appellants did not meet their burden of proving entitlement to their refund claims.⁸ Therefore, we find Hotel #3 subject to the annual \$800 LLC tax for the 2013 tax year, and Hotel #2 subject to the annual \$800 LLC tax for the 2013, 2014, and 2015 tax years.

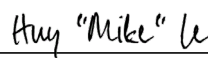
⁸ We do not address whether appellants were doing business under R&TC section 23101(a) because satisfying either R&TC section 23101(a) or R&TC section 23101(b) is sufficient to a nexus finding. (*Appeal of Aroya Investment I, LLC, supra.*)

HOLDING

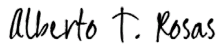
Appellants did not establish that they were not doing business in California under R&TC section 23101 and, therefore, appellants did not establish that they are not subject to the annual \$800 LLC tax.


DISPOSITION

We sustain respondent’s actions in full.

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Huy "Mike" Le
Administrative Law Judge

We concur:

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Alberto T. Rosas
Administrative Law Judge

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Kenneth Gast
Administrative Law Judge

Date Issued: 5/13/2021