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2022 – OTA – 247P
Pending Precedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19044718
MJK REAL ESTATE FUND II, LLC	)

OPINION

Representing the Parties:

For Appellant: Matthew J. Kearney, Manager

For Respondent: Judy F. Hirano, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, MJK Real Estate Fund II, LLC (appellant) appeals an action by respondent Franchise Tax Board (FTB) denying appellant's claims for refund of $800 for each of the 2013 through 2016 tax years. Pursuant to R&TC section 19331, appellant also appeals FTB's deemed denial of its $800 claim for refund for the 2017 tax year.

Appellant waived its right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellant was doing business in California and, therefore, subject to the annual $800 limited liability company (LLC) tax for the 2013 through 2016 tax years.
2. Whether the Office of Tax Appeals (OTA) has jurisdiction over the 2017 tax year and, if so, whether appellant was doing business in California for purposes of being subject to the annual $800 LLC tax for that year.

FACTUAL FINDINGS

1. For the tax years at issue, appellant, a Minnesota LLC, had a 5.21 percent profit sharing interest (profit interest), loss sharing interest (loss interest), and ownership of capital interest (capital interest) in FPA Governor Park Investors, LLC (Investors), a multi-member LLC classified as a partnership for income tax purposes.[1]
2. In 2008, the members of Investors, including appellant and another entity, PRIP 5060/6310, LLC (PRIP), contributed over $5 million in capital to purchase two real properties located in San Diego, California.
3. For the purchase of the properties, Investors and PRIP entered into a joint venture and formed FPA/PRIP Governor Park, LLC (FPA/PRIP). In 2013 and 2014, FPA/PRIP was a multi-member LLC classified as a partnership for income tax purposes. In those years, Investors had a 6.99 percent profit interest, a 52.35 percent loss interest, and a 52.35 percent capital interest in FPA/PRIP.[2] In 2015 and 2016, FPA/PRIP was a disregarded single-member LLC (SMLLC), and its 100 percent owner was Investors.[3]
4. FPA/PRIP was the sole owner of another disregarded SMLLC, FPA Governor Park Associates, LLC (Associates), that purchased the two San Diego, California real properties in 2008 for a total of $13 million.[4]
5. Appellant filed California income tax returns (Forms 568) for tax years 2013 to 2016 reporting and paying the annual $800 LLC tax for each of those years. The returns reported net rental real estate losses, which included flow-through rental income or losses from Investors and other pass-through entities. The 2016 tax return was filed on August 8, 2017, and reported an overpayment of $800 and requested that the amount be credited to the 2017 tax year.

[1] According to Investors' Schedules K-1, Investors had 58 members in 2013, 59 members in 2014, 59 members in 2015, and 58 members in 2016. The number of members for 2017 is unknown. Investors had 61 members in 2018.

[2] In 2013 and 2014, PRIP had a 93.01 percent profit interest, a 47.65 percent loss interest, and a 47.65 percent capital ownership interest in FPA/PRIP.

[3] FPA/PRIP's 2017 Form 568 is not in the record. However, there is no dispute that in 2017, FPA/PRIP was a disregarded SMLLC, and its 100 percent owner was Investors. The 2018 Form 568 for FPA/PRIP is in the record and indicates that those circumstances continued to be present in 2018.

[4] The purchase of the properties was funded by the capital contributions of over $5 million and a mortgage.

6. Appellant subsequently filed amended returns for 2013 through 2016 reporting zero tax and provided letters dated January 8, 2018, requesting a refund of the $800 LLC tax paid for each of those years. The letters state that appellant should not owe the $800 annual LLC tax due to the decision, *Swart Enterprises, Inc. v. Franchise Tax Bd*. (2017) 7 Cal.App.5th 497 (*Swart*). In addition, appellant states in one of those letters that it is requesting a refund of the $800 that was overpaid for 2016, "as well as the $800 that was being applied to the 2017 tax return." The 2016 amended return reported total payments of $1,600 for the 2016 tax year and requested a refund of $1,600.[5]
7. On August 14, 2019, appellant filed an untimely Form 568 for the 2017 tax year. The 2017 return reported the annual $800 LLC tax and did not report an overpayment or request a refund of this amount.
8. FTB considered appellant to have filed claims for refund for 2013 through 2016 and denied those claims.
9. This timely appeal followed.[6]

DISCUSSION

Issue 1: Whether appellant was doing business in California and, therefore, subject to the annual $800 LLC tax for the 2013 through 2016 tax years.

As applicable to the tax years at issue, every LLC is required to pay an annual tax to California for the privilege of doing business in this state equal to the applicable amount specified in R&TC section 23153(d) if the LLC is "doing business" in this state as defined in R&TC section 23101.[7] (R&TC, § 17941(a).) For the tax years at issue, this tax was $800. (R&TC, §23153(d).) Since 2011, R&TC section 23101 has contained two alternative bases for finding a taxpayer is "doing business" in this state. (*Wright Capital Holdings, LLC*, 2019-0TA-219P.) Doing business is defined in R&TC section 23101(a) as "actively engaging in any

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[5] $800 was reported as paid with FTB Forms 3537, 3522 and/or 3536, and $800 was reported as an overpayment from prior year.

[6] Appellant's Opening Brief notes that the appeal is "related to tax years 2013 through 2017" and is seeking a refund of $4,000 which is equal to the $800 annual LLC tax pair for each of the five tax years spanning from 2013 to 2017.

[7] Though not at issue here, an LLC is also required to pay the annual tax if its Articles of Organization have been accepted by the California Secretary of State (SOS) or a Certificate of Registration has been issued by the SOS. (R&TC, § 17941(b)(1).)

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transaction for the purpose of financial or pecuniary gain or profit." Under R&TC section 23101(b), a taxpayer is also considered to be doing business in California if it satisfies certain bright-line nexus thresholds consisting of sales, property, or payroll amounts.[8]

<u>Property Threshold under R&TC section 23101(b)(3)</u>[9]

With regard to the property threshold, R&TC section 23101(b)(3) provides that, for taxable years beginning on or after January 1, 2011, a taxpayer is doing business in this state for a taxable year if 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.[10] The threshold amounts, as adjusted for inflation each year, are as follows: (1) $51,816 in 2013; (2) $52,956 in 2014; (3) $53,644 in 2015; (4) $54,771 in 2016; and (5) $56,195 in 2017. (See R&TC, § 23101(c).) In determining whether a taxpayer has exceeded the California property threshold amount, the taxpayer must take into account its pro rata or distributive share of California property owned by pass-through entities in which it held an interest.[11] (R&TC, § 23101(d).) For purposes of R&TC section 23101(d), "pass-through entities" means a partnership or an S corporation. (*Ibid*.)

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 R&TC sections 25129 to 25131, inclusive, and the regulations thereunder, as modified by regulation under R&TC section 25137. (R&TC, § 23101(b)(3).) For purposes of applying the property threshold, "[p]roperty owned by the taxpayer is valued at its original cost." (R&TC, § 25130; see also

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[8] Though not at issue here, beginning on or after January 1, 2011, under R&TC section 23101(b)(1), a taxpayer also will be considered to be "doing business" in California if it is organized or commercially domiciled in this state.

[9] Because only the property threshold is at issue in this appeal, this Opinion does not address whether appellant exceeded the sales and payroll thresholds, pursuant to R&TC section 23101(b)(2) and (4).

[10] With regard to appellant's total real property and tangible personal property, the record indicates that appellant had an office outside of California and held interests in entities that owned property outside of California. FTB does not assert that appellant's California property exceeds the 25 percent threshold, and the matter is not in dispute. Therefore, the 25 percent threshold will not be addressed.

[11] As held in *Appeal of Aroya Investment I, LLC*, 2020-0TA-255P (*Aroya*), which applied R&TC section 23101(d) to an LLC taxed as a partnership, "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." (Original italics.) Therefore, R&TC section 23101(d) does not limit such amounts to those to where the taxpayer, pass-through entities, or both have income from within and without this state.

Appeal of LA Hotel Investments #3, LLC, 2021-OTA-218P.) "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).)

FTB's Application of R&TC section 23101(b)(3) to Appellant's 2013 and 2014 Tax Years

In 2013 and 2014, Associates, an SMLLC disregarded as a separate entity,[12] owned real property located in California with an original cost at the time of acquisition of $13 million.[13] The sole owner of Associates was FPA/PRIP, an LLC classified as a partnership for income tax purposes. Because Associates is a disregarded entity, the $13 million of California property is treated as owned directly by FPA/PRIP. Investors, which is an LLC classified as a partnership for income tax purposes, had a 52.35 percent capital interest and loss interest in FPA/PRIP, and a 6.99 percent profit interest in FPA/PRIP. Appellant had a 5.21 percent profit interest, loss interest, and capital interest in Investors.

For purposes of determining whether appellant meets the property threshold for doing business in California for 2013 and 2014, the property of appellant includes appellant's pro rata or distributive share of pass-through entities. (See R&TC section 23101(b)(3), (d).) FTB contends that appellant was doing business in California in 2013 and 2014 because its indirect share of the real property owned by FPA/PRIP, which flowed from FPA/PRIP to Investors to appellant, exceeded the $51,816 and $52,956 property thresholds for 2013 and 2014, as set forth in R&TC section 23101(b)(3). To calculate appellant's share of the real property, FTB first multiplied $13 million, which is the acquisition cost of the property, by 52.35 percent, which is Investors' capital interest percentage in FPA/PRIP, resulting in $6,805,500. FTB then multiplied $6,805,500 by 5.21 percent, which is appellant's capital interest percentage in Investors, resulting in $354,567. Accordingly, FTB determined that appellant's indirect share in FPA/PRIP's real property was $354,567 in 2013 and 2014, which exceeds the property threshold

[12] Where, as here, the SMLLC does not elect to be taxed as a corporation, it is disregarded and taxed as part of its owner. (*Bunzl Distribution USA, Inc. v. Franchise Tax Bd*. (2018) 27 Cal.App.5th 986, 993.)

[13] There is no dispute that the property value and original cost is $13 million for purposes of R&TC section 23101(b)(3).

amounts of $51,816 and $52,956 for 2013 and 2014, respectively, as set forth in R&TC section 23101(b)(3).

As noted above, FTB used Investors' capital interest percentage of 52.35 as Investors' "pro rata or distributive share" of FPA/PRIP to determine appellant's share of the real property. For 2013 and 2014, Investors had a 52.35 percent capital interest and loss interest, and a 6.99 percent profit interest in FPA/PRIP. If Investors' profit interest percentage (i.e., 6.99 percent) were used in place of its capital interest percentage (i.e., 52.35 percent), appellant would have an indirect share in FPA/PRIP's real property of $47,318 for 2013 and 2014 (i.e., $13 million x 6.99 percent[14] = $908,206; $908,206 x 5.21 percent = $47,318). Accordingly, if the profit interest (rather than the capital interest) is used to compute appellant's distributive share of the real property, appellant's real and tangible property in California would be less than the property thresholds of $51,816 and $52,956 for 2013 and 2014, respectively, and appellant would not be doing business in California during 2013 and 2014, pursuant to R&TC section 23101(b)(3). Therefore, whether appellant is doing business in California pursuant to R&TC section 23101(b)(3) depends on how appellant's "distributive share" is computed, pursuant to R&TC section 23101(d).

R&TC section 23101(d)

R&TC 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." FTB asserts that a partner's capital interest should be equated with a partner's pro rata or distributive share for purposes of R&TC section 23101(d) and contends that there is no language in the statute indicating the profit interest should be used.

The term "distributive share" is typically used in the context of federal partnership tax law, as described in Internal Revenue Code (IRC) sections 702 and 704, to which California conforms,[15] in relation to a partner's distributive share of partnership tax items, including

[14] The actual profit interest percentage is 6.9862 percent, which is used in this calculation, but rounded to 6.99 percent for purposes of the discussion.

[15] California incorporates IRC sections 701-761 relating to partners and partnerships with certain exceptions. (R&TC, § 17851; See *Appeal of Rios*, 2021-OTA-341P.) When applying those IRC sections, California incorporates Treasury Regulations promulgated under those IRC sections to the extent that they do not conflict with California Personal Income Tax Law (R&TC sections 17001 to 18181) or regulations promulgated by FTB. (R&TC, § 17024.5(d); see *Appeal of Rios*, *supra*.)

income, gain, loss, deduction, and credit, for the purpose of determining the partner's taxable income (or loss) for a particular year. Generally, a partner's distributive share of such partnership tax items shall, except as otherwise provided, be determined by the partnership agreement, and shall be determined in accordance with the partner's interest in the partnership (taking into account all facts and circumstances), if: (1) the partnership agreement does not provide for the partner's distributive share; or (2) the allocation to a partner under the agreement does not have substantial economic effect. (IRC, § 704(a), (b); Treas. Reg. § 1.704-1(a), (b)(1).)

However, there is ambiguity in the language of R&TC section 23101(d), which does not specify that the "distributive share" is applicable to a particular tax item, such as the partnership's income or loss, as the term is typically used in IRC sections 702 and 704, but rather states "distributive share of pass-through entities." There is also ambiguity given the context and purpose of R&TC section 23101(b), which does not examine a taxpayer's distributive share of tax items to compute the taxpayer's taxable income and loss during a particular year, as described in IRC section 702, but rather examines the taxpayer's share of the partnership's sales, property, and payroll in this state to determine nexus.[16] Thus, the meaning of "distributive share" for purposes of R&TC section 23101(d) is unclear; and, in the context of R&TC section 23101(d), it is uncertain whether the term was intended to represent or be ascertained by applying the taxpayer's capital interest, as FTB contends, or whether another meaning was intended or should be applied, such as utilizing another partnership interest, such as the profits interest.[17]

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[16] The Legislative history of the amendment to R&TC section 23101 to add the nexus thresholds states that the thresholds are "de minimus exemptions," but does not provide guidance as to the computation of the taxpayer's "distributive share" in computing the partnership's share of sales, property, and payroll. (See CA B. An., A.B.X3 15 Sen., 2/14/2009.) OTA notes that the Multistate Tax Commission (MTC) recommended a factor presence nexus model which included thresholds of $50,000 of property, $50,000 of payroll, and $500,000 of sales, adjusted for inflation. (See Miscellaneous Multistate Materials (RIA) ¶ 172 Factor Presence Nexus Standard for Business Activity Taxes Approved by the MTC October 17, 2002 (MTC Model).) Subsequently, California amended the doing business standard under R&TC section 23101(b) to include similar nexus thresholds and amounts, adjusted for inflation.

[17] A capital interest has been defined as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at their fair market value and then the proceeds were distributed in a complete liquidation of the partnership.17 (See *Crescent Holdings, LLC v. Commissioner* (2013) 141 T.C. 477, 488; *Krause v. Commissioner* (1989) 92 T.C. 1003, 1019.) A profit interest in a partnership has been defined as the amount to which a partner is entitled to the future profits of the partnership. (*Hill, Farrer & Burrill v. Commissioner* (1976) 67 T.C. 411, 419; see also *Mark IV Pictures, Inc. v. Commissioner* (1990) T.C. Memo. 1990-571, aff'd (8th Cir. 1992) 969 F.2d 669.)

R&TC section 23101's Reference to the Regulations under R&TC section 25137

OTA requested that FTB address whether California Code of Regulations, title 18, (Regulation) section 25137-1, specifically subdivision (f)(4), could be used for guidance in determining appellant's distributive share under R&TC section 23101(d). FTB argues that R&TC section 23101(d) does not reference, and has no connection to, Regulation section 25137-1. FTB also asserts that Regulation section 25137-1(f)(4) is not relevant in determining the value or location of property for purposes of R&TC section 23101(b). However, with regard to the property threshold, R&TC section 23101(b)(3) states that 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 R&TC sections 25129 to 25131, inclusive, and the regulations thereunder (i.e., the property factor rules), as modified by regulation under R&TC section 25137.

Regulation section 25137-1(f)(1) provides guidance in determining the value of partnership property in this state for purposes of computing the property factor to be used, when applicable, in apportioning the taxpayer's distributive share of partnership business income.[18] For instance, Regulation section 25137-1(f)(1)(A) provides the "partnership's real and tangible personal property… to the extent of the taxpayer's interest in the partnership, shall be included in the denominator of the taxpayer's property factor. The value of such property located in this state shall also be included in the numerator of the property factor." Regulation section 25137-1(f)(1) also includes examples, such as Example 2, which provides that "the value of the building [property] to be used in the property factor" for a partner is computed by multiplying the partner's percentage interest in the partnership by the value of the property. Therefore, both Regulation section 25137-1(f)(1) and R&TC section 23101(b)(3) address the value of property in this state. And as noted above, R&TC section 23101(b)(3) states that the value of property and whether it is in this state is to be determined using the property factor rules provided in R&TC

[18] *Aroya*, *supra*, held that, for purposes of R&TC section 23101(d), all pro rata or distributive share amounts should be taken into account, regardless of whether the entities are engaged in a unitary business, but did not address what "distributive share" means in the nexus context. OTA finds the unitary method of apportionment under Regulation section 25137-1(f) relevant for purposes of determine what "distributive share" means in the context of R&TC section 23101(d). Unlike the non-unitary method of apportionment under Regulation section 25137-1(g), Regulation section 25137-1(f) provides that the apportionment factors of both the partner and partnership are combined in apportioning the partner's distributive share of partnership business income.

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section 25129 to 25131, inclusive, as modified by the regulations under R&TC section 25137.[19] Accordingly, Regulation section 25137-1 will be examined for guidance in resolving the ambiguity under R&TC section 23101(d).

Regulation section 25137-1

Regulation section 25137-1(f)(4) states that a "taxpayer's partnership interest for the purpose of computing the portion of the partnership's property, payroll and sales to be included in the taxpayer's property, payroll or sales factor shall be determined by the taxpayer's 'interest in the partnership'." Prior to January 1, 2019, Regulation section 25137-1(f)(4) stated that the "taxpayer's interest in the partnership shall be determined under Chapter 10 [Partners and Partnerships] of Part 10 of Division 2 of the Revenue and Taxation Code, and the regulations thereunder." Effective January 1, 2019, Regulation section 25137-1(f)(4) was amended to clarify that the "taxpayer's interest in the partnership shall be determined by reference to its interest in profits of the partnership."[20]

OTA requested that FTB address whether the profit interest should be used for R&TC section 23101(d) to be consistent with the amendment to Regulation section 25137-1(f)(4). FTB notes that the amendment to Regulation section 25137-1(f)(4) was effective January 1, 2019, and does not apply to tax years 2013 to 2017, at issue here. FTB asserts that, before the amendment, the understanding and practice of FTB and the taxpayer and tax practitioner community was to use the capital interest as the taxpayer's interest in the partnership. In support, FTB refers to its Initial Statement of Reasons for the amendment, which states that "the capital of the partnership… is the current partnership interest that's referenced for purposes of determining the portion of the unitary partnership apportionment factors…." Therefore, FTB argues that

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[19] In addition, R&TC section 23101(b)(2) states that "sales in this state shall be determined using the rules for assigning sales under Sections 25135 and 25136 and the regulations thereunder, as modified by regulations under Section 25137," and R&TC section 23101(b)(4) states that "[c]ompensation in this state shall be determined using the rules for assigning payroll contained in Section 25133 and the regulations thereunder, as modified by regulations under Section 25137."

[20] FTB's Final Statement of Reasons for the proposed amendments to Regulation section 25137-1 states that "the applicable tax schedule that reflects the partner's distributive share of partnership tax items, the Schedule K-1, will reflect the percentage of the partner's interest in the profits of the partnership."

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consistency with Regulation section 25137-1 is not an appropriate reason for using the profit interest for R&TC section 23101(d).[21]

However, FTB's regulatory documentation indicates that it was not the common understanding and practice to use the capital interest as the partner's "interest in the partnership" for purposes of Regulation section 25137-1(f), and instead, indicates that there was uncertainty. FTB's Discussion Topics for the amendment states that "[s]ubsection (f)(4) is revised to provide greater clarity for the term 'interest in the partnership'. This change is offered to address the uncertainty in the existing regulation's definition of 'partnership interest'."[22] A separate Discussion Topics document on the amendment issued by FTB states:

> [A] partner's 'interest' under the current regulation is difficult to determine. For example, a partnership agreement might provide that a partner's share of current income is different than the partner's share of current losses and the partner's share of the partnership's assets in liquidation. Thus, in any given year a partner's percentage share of distributive share items may be different than the partner's 'partnership interest percentage.' Should Regulation 25137-1(f) be amended to assign property, payroll, and sales to a unitary partner based on the partner's percentage of distributive share items for the taxable year?[23]

As previously noted, prior to the amendment, Regulation section 25137-1(f)(4) stated that the taxpayer's partnership interest should be determined pursuant to Chapter 10 [Partners and Partnerships] of Part 10 of Division 2 of the Revenue and Taxation Code, and the regulations thereunder. R&TC section 17851 incorporates IRC section 704, which provides that a partner's interest in a partnership is determined by taking into account all facts and circumstances. (IRC, § 704(b).) Treasury Regulation section 1.704-1(b)(3) provides that a "partner's interest in the partnership" signifies "the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item

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[21] FTB also contends that, for purposes of R&TC section 23101(d), the capital interest should be used, as that is comparable to a stock ownership in an S corporation. However, a shareholder's "pro rata share" of pass-through items of an S corporation are allocated according to stock ownership of the shareholder. (See IRC, §§ 1366(a), 1377(a).) An S corporation can only have one class of stock, whereas a partner can have more than one type of interest in a partnership; and unlike a partnership, an S corporation generally cannot make allocations that vary from the underlying interest. (See IRC, § 1361(b)(1)(D); see also Treas. Reg. § 1.1361-1(l)(1).)

[22] https://web.archive.org/web/20150922035036/https://www.ftb.ca.gov/law/regs/25137/07082014_Discussion_Topics.pdf

[23] https://web.archive.org/web/20150921220812/https://www.ftb.ca.gov/law/intParty/25137_1_Discussion_Topics.pdf

thereof) that is allocated." Treasury Regulation section 1.704-1(b)(3) further provides that "the determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners," and includes factors such as the partners' relative contributions to the partnership, the partners' interests in economic profits and losses, the partners' interests in cash flow and other non-liquidating distributions, and the partners' rights to distributions of capital on liquidation. (Treas. Reg. § 1.704-1(b)(3)(ii).)

Thus, prior to the amendment, the partner's "interest in the partnership" for purposes of computing the partner's portion of the partnership's property, payroll, and sales under Regulation section 25137-1 was not exclusively understood or defined as solely the partner's "capital interest" in the partnership, as FTB contends, and there was uncertainty in the definition of the partner's "interest in the partnership" in Regulation section 25137-1 prior to the amendment.[24]

R&TC section 23101 and Regulation section 25137-1

FTB argues that R&TC section 23101 and Regulation section 25137-1 serve different purposes, as the former is used to determine nexus and the latter to apportion a partner's business income from a partnership. However, it is logical that the calculation of a partner's property in this state for the purpose of determining nexus should be consistent with how the partner's business income from the partnership is apportioned using the property factor under Regulation section 25137-1, as opposed to having two separate rules.[25] While R&TC section 23101(d) and Regulation section 25137-1 serve different purposes, both are essentially intended to assign property to California: one for the purpose of determining nexus, and one for the purpose of apportionment. Accordingly, consistent with Regulation section 25137-1, OTA finds that the

[24] As a result, using the profit interest to determine the distributive share for R&TC section 23101(d) would not be inconsistent with Regulation section 25137-1, as FTB contends, because prior to the amendment, the regulation did not define the partner's interest in the partnership as solely the partner's capital interest in the partnership, and a profit interest is also an interest in the partnership.

[25] In fact, FTB guidance (both before and after the amendment), appears to provide the same computation table should be used for R&TC section 23101(b) and Regulation section 25137-1(f). Specifically, FTB instructs that the partnership should report in Table 2, Part C, the partner's distributive share of property, payroll, and sales, which the partner will use to determine if the nexus thresholds are met, and subsequently also provides that Table 2, Part C is also used to determine the apportionment factors. (See e.g., https://www.ftb.ca.gov/forms/2015/15_568bk.pdf, pgs. 22, 44; https://www.ftb.ca.gov/forms/2020/2020-568-booklet.pdf, pp. 23, 39.) While FTB's instructions are not binding authority, this illustrates how applying two separate rules for purposes of nexus and apportionment may add unnecessary complexity and confusion for both taxpayers and FTB.

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partner's interest in the partnership should be used in computing the partner's distributive share in the partnership under R&TC section 23101(d).[26] However, as noted above, a partner's interest in the partnership was not expressly defined in Regulation section 25137-1(f)(4) prior to the amendment, and it is not clear how the interest would be computed in this case where appellant has a 6.99 percent profit interest and a 52.35 percent loss and capital interest.

In FTB's Explanation of Discussion Draft for the proposed amendment, it stated that the reason for the amendment to Regulation section 25137-1 was because it was believed the profit interest percentage is "more closely tied to the income subject to apportionment than a capital interest approach would provide."[27] In addition, FTB stated that using the profit interest would be "easier to audit." While the amendment is not applicable to the years at issue in this appeal, the reasoning for the amendment is persuasive in resolving the ambiguity in R&TC section 23101(d) and Regulation section 25137-1(f)(4). OTA also finds that, should a taxpayer be found to have nexus and income subject to apportionment, the profit interest is more closely tied to that income, and this reasoning is equally applicable to the tax years before the amendment. Given that R&TC section 23101(b) provides that Regulation section 25137-1 should be used in determining the property, payroll, and sales in this state, OTA finds that the profit interest should be applied to determine the partner's distributive share under R&TC section 23101(d).

FTB contends that using the capital interest is inconsistent with the purpose of R&TC section 23101(b)(3), which addresses the value and location of property, and that the profit interest is more applicable as it entitles the holder to proceeds from the sale of partnership assets if the partnership was in complete liquidation. However, in determining the sales in this state, FTB would presumably argue the profit interest should be used, as it is more closely tied with sales. And it is unclear what factor could be used for payroll if this reasoning were applied in

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[26] As previously noted, California adopted property, payroll, and sales nexus thresholds similar to the thresholds in the MTC factor presence nexus model. The MTC model states that [t]he property, payroll and sales for measuring against the nexus thresholds shall be defined as they are for apportionment purposes…." (MTC Model.) While not binding, OTA finds the MTC model to be instructive and consistent with the language of R&TC section 23101(b), which states that the regulations under R&TC section 25137 should be used to determine the value of property in this state.

[27]https://web.archive.org/web/20150922035036/https://www.ftb.ca.gov/law/regs/25137/07082014_Discussion_Topics.pdf

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that context.[28] FTB's reasoning here would result in inconsistency and would require the use of different partnership interests to be used in determining a single taxpayer's potential nexus (i.e., profit interest for sales, capital interest for property, etc.).

Applying such varying interests would be inconsistent with Regulation section 25137-1, which R&TC section 23101(b) states should be used for determining the property, payroll, and sales in this state. Regulation section 25137-1 does not provide for the application of varying interests to each factor, such as the profit interest for sales and capital interest for property, and as stated by FTB, the profit interest is the most relevant interest for purposes of Regulation section 25137-1.[29] In addition, using the same methodology for R&TC section 23101 and Regulation section 25137-1, as amended, is consistent with the purpose of facilitating reporting and administration. Accordingly, OTA finds that the profit interest should be used in determining appellant's distributive share of the property of Investors.

Application of R&TC section 23101(b)(3) to Appellant's 2013 and 2014 Tax Years

Investors had a 6.99 percent profit interest in FPA/PRIP, an LLC taxed as a partnership, during the 2013 and 2014 tax years. Appellant's profit, loss, and capital interests in Investors were all 5.21 percent in 2013 and 2014. Since appellant had a 5.21 percent profit interest in Investors, that percent of the California property value flowed through to appellant. Using the profit interest percentage results in property of $47,343 in California for appellant for 2013 and 2014 (i.e., ($13 million x 6.99 percent) x 5.21 percent = $47,343).[30] This amount does not exceed the property threshold amounts of $51,816 and $52,956 for 2013 and 2014, respectively, under R&TC section 23101(b)(3). Thus, appellant was not doing business in California for the

[28] Regulation section 25137-1(f) was amended to apply the profit interest in assigning the partnership's property, payroll, and sales, whereas FTB argues that the capital interest is the more applicable to property. However, as noted above, Regulation section 25137-1(f) was amended in consideration of what would be easier to audit and the intent of the regulation as a whole, i.e., apportioning income, instead of the relevance or applicability of a particular partnership interest to each individual apportionment factor.

[29] In addition, the language in R&TC section 23101(d) directs taxpayers to include their "distributive share of pass-through entities" in determining the "sales, property, and payroll of the taxpayer," which indicates a single distributive share percentage applies equally to property, payroll, and sales.

[30] FTB also objects to the use of the profit interest because it contends that the allocation of income does not have substantial economic effect but FTB does not provide any specific arguments. OTA concludes that the profit interest as reflected on the K-1 is consistent with how the partners of FPA/PRIP agreed to share the economic benefits and burdens corresponding with the allocation of income in the LLC agreement, and the allocation of income is proper for purposes of R&TC section 23101(d). (See Treas. Reg. § 1.704-1(b)(1)(i), (b)(3).)

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2013 and 2014 tax years, pursuant to R&TC section 23101(b)(3). However, appellant may still be doing business under R&TC section 23101(a), which is examined next.

Application of R&TC section 23101(a) to Appellant's 2013 and 2014 Tax Years

R&TC section 23101(a) 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." In *Swart*, *supra*, 7 Cal.App.5th 497, the court held that an out-of-state taxpayer was not "doing business" in California, pursuant to R&TC section 23101(a), because it held a small (0.2 percent), non-managing member interest in a manager-managed LLC investment fund. (See also *Wright Capital Holdings, supra*.) The court reasoned that the taxpayer was not "doing business" in California because it had no interest in specific property of the LLC, was not personally liable for the LLC's obligations, played no role in the LLC's management and had no right to, and could not act as an agent for the LLC or bind the LLC in any way. (*Swart*, *supra,* 7 Cal.App.5th at pp. 507-513; see also *Wright Capital Holdings, supra*.) In essence, the court found that the taxpayer in *Swart* was more akin to a limited partner than a general partner, and the law is clear that the doing business status of a limited partnership is not attributed to a partnership's limited partners. (*Swart*, *supra,* 7 Cal.App.5th at pp. 507-513; see also *Wright Capital Holdings, supra*.)

In this case, appellant had a 5.21 percent profit interest, loss interest, and capital interest in Investors in 2013 and 2014. Investors was manager-managed by a different entity. The record includes the operating agreement and investor memorandum for Investors, and an agreement between Investors and appellant, which describe the authority of the manager of Investors. This evidence does not indicate that appellant had any authority to manage Investors.[31] The facts here are comparable to those of *Swart*, *supra*, 7 Cal.App.5th 497, and *Appeal of Jali*, *LLC*, 2019-OTA-204P, which held that the taxpayer did not have any ability or authority, directly or indirectly, to influence or participate in the management or operation of the

[31] FTB asserts that, unlike in *Swart*, *supra*, 7 Cal.App.5th 497, appellant, as an original member of Investors, exercised control by relinquishing that control to the manager. However, the court in *Swart* noted that in *Moulin v. Der Zakarian* (1961) 191 Cal.App.2d 184, the right to relinquish control was only one factor in determining whether a general partnership was formed by an agreement. (See *Swart*, *supra*, 7 Cal.App.5th at p. 512-513.) The court also noted that LLC members only have the right to remove the manager by a majority vote. (*Swart*, *supra,* 7 Cal.App.5th at p. 513, citing Corp. Code, § 17704.07(c)(5).) Similar to *Swart*, OTA finds that appellant's minimal interest, requiring majority consent, would not give it the right to manage or control Investors, particularly where this right was never exercised. (See *Swart*, *supra,* 7 Cal.App.5th at p. 513.)

partnership.[32] In addition, appellant's interest of 5.21 percent in Investors is comparable to the interests of the taxpayer in *Appeal of Jali, supra*, which ranged from 1.12 percent to 4.75 percent. The record shows that appellant's interest in Investors more closely resembles that of a limited, rather than a general, partner. Therefore, appellant was not doing business in California under R&TC section 23101(a) and is not subject to the annual $800 LLC tax for the 2013 and 2014 tax years.

Application of R&TC section 23101(b)(3) to Appellant's 2015 and 2016 Tax Years

In 2015 and 2016, Associates, a disregarded entity, still owned the real property located in California with an acquisition cost of $13 million. FPA/PRIP was still the sole owner of Associates. But, unlike 2013 and 2014 (when Investors had a 6.99 profit interest and 52.35 loss and capital interest in FPA/PRIP), FPA/PRIP was now a disregarded SMLLC wholly owned by Investors. Thus, because both Associates and FPA/PRIP were disregarded entities wholly owned by Investors, the $13 million of California property was treated as owned directly by Investors for income tax purposes. Appellant had a 5.21 percent profit interest, loss interest, and capital interest in Investors. To calculate appellant's share of the real property, FTB multiplied $13 million, which is the acquisition cost of the property, by 5.21 percent, resulting in $677,300. Accordingly, appellant's indirect share in Investors' real property in California was $677,300 in 2015 and 2016, which exceeded the property thresholds of $53,644 and $54,771 for 2015 and 2016, respectively. Thus, appellant was doing business in California for the 2015 and 2016 tax years, pursuant to R&TC section 23101(b)(3).

Appellant contends that it was not doing business in California pursuant to R&TC section 23101(a) and *Swart, supra,* 7 Cal.App.5th 497. However, 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. (*GEF Operating, Inc*., *supra*; *Appeal of Aroya Investment I, LLC*, 2020-OTA-255P (*Aroya*); see also *Swart*, *supra*, 7 Cal.App.5th at p. 503, fn. 2). Because appellant's California property exceeded the bright-line threshold amount under R&TC section 23101(b)(3) for 2015 and 2016, it is doing business in this state for those tax years. Therefore, it is unnecessary to analyze whether

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[32] In addition, appellant did not have a direct interest in any property in California. LLC members hold no direct ownership interest in the LLC's specific property. (See *Swart*, *supra*, 7 Cal.App.5th 497, 510; see also *Kwok v. Transnation Title Ins. Co*. (2009) 170 Cal.App.4th 1562, 1570-1571.)

appellant is also doing business under R&TC section 23101(a) and *Swart*. (*Aroya*, *supra*; *Appeal of LA Hotel Investments #3, LLC*, *supra*.)

Appellant argues that *Aroya*, *supra*, can be distinguished because the taxpayer in that case acquired its interest in December 2014, nearly four years after the amendment of R&TC section 23101 that added subdivisions (b) to (d), whereas appellant acquired its interest in 2006. However, the law that applies to a particular tax year is the law in effect for that tax year, taking into account any amendments to the applicable tax statute. (See, e.g., *Power v. Commissioner*, T.C. Memo. 2016-157, fn. 7 [law applicable to net operating loss carryovers generated in 1999-2002 was the applicable IRC section 172 provision as amended in 1997].) Therefore, in determining whether appellant's California property exceeded the property threshold pursuant to R&TC section 23101(b)(3), appellant's California property for the tax year at issue and the applicable law for that year is examined, instead of the law applicable to the year in which the property was acquired.[33]

Appellant also argues that *Swart*, *supra*, 7 Cal.App.5th 497, must be considered because FTB denied appellant's claim for refund using a *Swart* analysis. Specifically, FTB's Claim for Refund Denial states: "You did not meet one or more of the above facts as per the *Swart* decision." However, FTB's denial of the claims and determination that appellant was doing business in California based on R&TC section 23101(a) and *Swart*, does not preclude us from applying applicable legal authorities and determining that appellant is doing business under R&TC section 23101(b)(3).[34]

Appellant also asserts that it should be entitled to a refund of the $800 LLC tax it paid for the 2006 through 2010 tax years. However, OTA does not have jurisdiction over the 2006 through 2010 tax years because appellant has not provided any evidence that it filed claims for refund for the 2006 through 2010 tax years, and that FTB either denied the claims or six months

[33] In addition, appellant contends that it only had a passive interest. However, whether an ownership interest is passive or active is not relevant to our analysis under R&TC section 23101(b)(3) and (d). (*Aroya*, *supra*.)

[34] If FTB's position on appeal either alters the original deficiency or requires the presentation of different evidence, then a new matter has been introduced, and the burden of proving that new position shifts to FTB. (*Appeal of Mendelsohn* (85-SBE-141) 1985 WL 15923.) However, in this appeal, there is no need to determine whether the burden shifted to FTB because regardless of who has the burden, OTA finds there is a preponderance of evidence showing that appellant was doing business in California.

has passed since the filing of the claims such that they can be deemed denied pursuant to R&TC section 19331.[35] (See Cal. Code of Regs., tit. 18, § 30103(a).)

Issue 2: Whether OTA has jurisdiction over the 2017 tax year, and, if so, whether appellant was doing business in California for purposes of being subject to the annual $800 LLC tax for that year.

OTA Jurisdiction

Appellant asserts that its January 8, 2018 letter was a refund claim for 2017. The letter states that appellant is amending its 2016 California return to reflect a tax of zero, and that it is requesting a refund of the $800 that was overpaid for 2016, "as well as the $800 that was being applied to the 2017 tax return." Every claim for refund shall be in writing, shall be signed by the taxpayer or the taxpayer's authorized representative, and shall state the specific grounds upon which it is founded. (R&TC, § 19322.) In this case, the letter satisfies the requirements of R&TC section 19322 because it is in writing, is signed by appellant's authorized representative, specifies that it is seeking a refund of $800 for the 2017 tax year, and states the grounds for the claim by requesting a refund due to *Swart*, *supra*, 7 Cal.App.5th 497.

Appellant asserts that it requested that the 2016 overpayment be applied to the 2017 tax year when it filed its 2016 return on August 8, 2017. FTB contends that, according to its record for the 2016 tax year, there was no $800 payment for the 2016 tax year that was credited and applied to the 2017 tax year. However, FTB does not provide its records for the 2017 tax year to verify the date of the 2017 payment and whether this payment was made before or after appellant's January 8, 2018 claim for refund letter.[36]

Nevertheless, R&TC section 19322.1(a) provides that a claim for refund of tax that is otherwise valid under R&TC section 19322, but is made before the full payment of the disputed

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[35] In addition, appellant acknowledges that the statute of limitations for filing such claims for refunds for these tax years has passed.

[36] Because FTB has not provided its records for the 2017 tax year, OTA is unable to determine if $800 was in fact transferred from appellant's 2016 tax year and applied to the 2017 tax year and, if so, the effective date of this transfer. R&TC section 19383 provides that "[p]ayments that are transferred from another tax year are effective as of the date the payments are transferred." Appellant filed its 2016 return on August 8, 2017, asking that its $800 overpayment for the 2016 tax year be transferred and applied to its 2017 tax year. If appellant in fact had a $800 overpayment for the 2016 tax year, this overpayment should have been applied to appellant's 2017 tax year shortly after appellant filed and FTB accepted appellant's 2016 tax return requesting such transfer. This return was filed five months before appellant's January 8, 2018 claim for refund letter.

tax has been made, shall be a claim only for purposes of tolling the statute of limitations. This informal claim for refund will be perfected and deemed filed on the date when the full payment of the tax is made. (R&TC, § 19322.1(a).) Therefore, because the 2017 claim for refund is otherwise valid under R&TC section 19322, it will be considered an informal claim for refund which was perfected and deemed filed when the payment for the 2017 tax year was made or applied.

FTB also argues that the letter is not a claim for refund because appellant did not file a 2017 return until after the denial of the claims for refund for 2013 through 2016. However, generally a valid return is not required to be filed in order for a taxpayer to file a claim for refund, as long as the statutory requirements of R&TC section 19322 are met. (See *Appeal of Reed*, 2021-OTA-326P.)[37] As noted above, appellant's letter meets the requirements of R&TC section 19322.[38] Thus, the letter is valid claim for refund even though it was filed prior to the filing of appellant's 2017 return.

If FTB fails to mail notice of action on any refund claim within six months after the claim is filed, the taxpayer may prior to mailing of notice of action on the refund claim consider the claim disallowed and appeal to OTA. (R&TC, § 19331.) OTA has jurisdiction to hear and decide an appeal that has been timely submitted to OTA if FTB fails to act on a claim for a refund of tax, penalties, fees, or interest within six months after the claim is filed with FTB. Accordingly, OTA finds there was a deemed denial of the claim for purposes of OTA's jurisdiction. (Cal. Code Regs., tit. 18, § 30103(a)(4).)

<u>Application of R&TC section 23101(b)(3) to the 2017 Tax Year</u>

FTB states that, should OTA decide it has jurisdiction over the 2017 tax year, appellant was doing business in California under R&TC section 23101(b)(3) and was thus subject to the annual $800 LLC tax. The record indicates that the analysis and conclusion with respect to tax

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[37] In *Appeal of Reed*, *supra,* OTA held appellant's claim for refund for the 2017 tax year was valid (and that OTA therefore had jurisdiction), despite the fact that appellant had failed to file a valid tax return for the 2017 tax year. However, OTA also found that appellant's failure to file a valid tax return barred appellant from receiving the refund requested. This was based on specific language contained in R&TC section 19307 which provides: "No refund or tax withheld or estimated tax paid shall be allowed to an employee or taxpayer who fails to file a return for the taxable year in respect of which the tax withheld or estimated tax was allowable as a credit." Here, there is nothing in the record to indicate that the $800 payment made for the 2017 tax year was an estimated tax payment, and in any event, appellant has now filed a valid return for the 2017 tax year.

[38] The statute of limitations is not at issue with respect to the 2017 tax year.

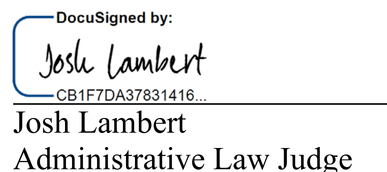
years 2015 and 2016 as described above also apply to the 2017 tax year. There is no evidence that the LLC profit, loss, and capital interests materially changed between 2016 and 2017. As with 2015 and 2016, there is no dispute that appellant's California property exceeds the property threshold under R&TC section 23101(b)(3). Appellant only argues that, based on the analysis in *Swart*, it was not doing business in California under R&TC section 23101(a). However, there is no need to address subdivision (a) because appellant meets the bright-line threshold under subdivision (b). Therefore, appellant has not provided any evidence to show that it does not exceed the property threshold under R&TC section 23101(b)(3) and, as a result, it was doing business in California in 2017.

HOLDINGS

1. Appellant was not doing business in California and is not subject to the annual $800 LLC tax for the 2013 and 2014 tax years. Appellant was doing business in California and is subject to the annual $800 LLC tax for the 2015 and 2016 tax years.
2. OTA has jurisdiction over the 2017 tax year, and appellant is not entitled to a refund of the annual $800 LLC tax for that year because it was doing business in California.

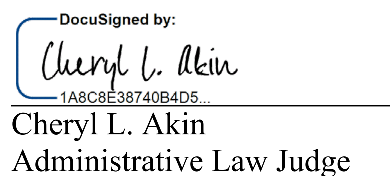
DISPOSITION

FTB's actions are modified to refund the annual $800 LLC tax for the 2013 and 2014 tax years. FTB's actions are otherwise sustained.



Josh Lambert
Administrative Law Judge

We concur:



Cheryl L. Akin
Administrative Law Judge

Huy "Mike" Le
Administrative Law Judge

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