The M&A Tax Report

FEBRUARY 2013 VOLUME 21, NUMBER 7 The Monthly Review of Taxes, Trends & Techniques

California Sourcing and M&A

By Robert W. Wood • Wood LLP

When can California tax you? Even if you are not sitting in the Golden State, you may have some income and that is fair game. California taxes are frightening, and they are becoming more so. Of course, the Golden State represents a wealth of opportunities. Yet it has its costs too, and they are rising.

New Deal

Talk of California taxes may have been eclipsed by the fiscal cliff drama. But California too is taking taxes seriously and trying to sock it to the rich. California's Proposition 30, passed in November 2012, created three new upper-income tax brackets for the next seven years.

As one example, a taxpayer with $250,000 to $300,000 a year in income will pay California 10.3 percent, up from 9.3 percent. And as one climbs the income ladder, the new top income tax rate for Californians with income of $1 million or more is now 13.3 percent, up from the previous top rate of 10.3 percent. If these state tax rates seem high, it's because they are.

In fact, the outsize 13.3-percent figure eclipses even New Yorkers' combined top state and local rate of 12.7 percent and Hawaii's top rate of 11 percent. Bear in mind that these California tax increases aren't just for 2013 and future years. These California tax increases passed in November 2012 were made retroactive to January 1, 2012.

Proposition 30 also raises the California sales tax from 7.25 percent to 7.5 percent for four years, starting January 1, 2013. With the local add-ons that can make sales and use tax administration in California a nightmare, the sales tax in some California counties is now 10 percent.

In an age of many LLC membership interests, what can be considered to produce California-source income? When do California withholding requirements apply? Some of the answers seem clear, but many are surprisingly murky with a kind of "it depends" latitude that business people can and do find worrisome.

LLC Membership Interests

Whether the sale of membership interests in an LLC will produce California-source income appears to depend primarily on two inquiries:

- Are the membership interests intangible assets?
- If they are, have those intangible assets established a business/taxable situs in California?

Irrespective of business/taxable situs, if the sale of membership interests is viewed as part of a process of doing business in California, that could also produce California-source income. This latter topic is particularly amorphous.

There is relatively little authority on the specific question of whether LLC membership interests constitute intangible property. However, there is comforting authority that partnership interests constitute intangible property. As does most states, California applies partnership tax law to LLCs. In many respects, other substantive bodies of law drawing from partnership and corporate law are applied to LLCs.

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646.
Subscription inquiries should be directed to
4025 W. Peterson Ave., Chicago, IL 60646.
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California Taxes and Fees on LLCs

A reasonable starting place is the California taxes and fees on LLCs in the state. Aside from any California-source income that flows through to LLC members, LLCs that file in California are subject to an $800 minimum tax and also to a fee (which varies depending on income derived from California sources). Under California Revenue and Taxation Code Section 17941, LLCs that are "doing business" in California, whose articles of incorporation have been accepted by the Secretary of State, or for whom the Secretary of State has issued a certificate of registration must pay an annual minimum tax of $800.

Doing business in California means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." LLCs subject to the minimum tax under Section 17941 are also required to pay an annual fee to California for the tax year, based on the "total income from all sources derived from or attributable" to California. The fee is:

1. $900 for total income equal to or greater than $250,000 but less than $500,000;
2. $2,500 for total income equal to or greater than $500,000 but less than $1 million;
3. $6,000 for total income equal to or greater than $1 million but less than $5 million; and
4. $11,790 for total income equal to or greater than $5 million.

In this context, "total income from all sources derived from or attributable" to California means gross income (defined under Revenue and Taxation Code Section 24271) "plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer."

For purposes of calculating California's annual fee, total income does not include an allocation or attribution of income or gain, or distributions made to LLC members of another LLC, "if the allocation or attribution of income or gain or distributions are directly or indirectly attributable to income that is subject to the payment" of the minimum fee.

California-Source Income

Under Revenue and Taxation Code Section 17041, California taxes nonresidents on income derived from California sources. Revenue and Taxation Code Section 17951(a) defines the taxable income of nonresidents to include "only the gross income" derived from California

sources. Under Regulation 17951-1(b), the gross income of a nonresident member of a partnership "includes, in addition to any other income from sources within this State, the partner's distributive share of the taxable income of the partnership ... to the extent that the member's distributive share is derived from sources within this State."

Income from sources within California includes: (1) income from real or tangible personal property located in California; (2) income from a business, trade or profession carried on in California; (3) compensation for personal services performed within California; and (4) "income from stocks, bonds, notes, bank deposits and other intangible personal property having a business or taxable situs in" California.

On the other hand, according to Revenue and Taxation Code Section 17952, "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this State unless the property has acquired a business situs in this State ... ." This raises questions of whether an LLC membership interest is intangible personal property, and if it is, whether that property acquired a business situs in California.

LLC Membership Interests as Intangible Personal Property

There appears to be no published California decision, statute or regulation that officially reaches this conclusion with respect to LLCs. However, an annotation to Title 18 of the California Administrative Code, Section 1702, states that absent an agreement terminating the LLC upon transfer of its membership interest, the transfer of an LLC membership interest "is treated as a transfer of intangible personal property the sale of which is not subject to sales tax." Of course, this rule mentions intangible treatment for California sales tax purposes, not for California income tax purposes.

Of course, for California income tax purposes, LLCs are classified as partnerships. That means the rules applicable to taxation of partnerships would apply for LLCs. The California appellate case of *Valentino v. Franchise Tax Bd.*, 87 Cal. App. 4th 1284, 1295 (2001), states unequivocally that "[p]artnership interests are intangible property...." Similarly, SBE opinions (although technically nonprecedential) have also construed a limited partnership interest as intangible personal property.

LLC Membership Interests Establishing Taxable Situs in California

Taxable situs is another matter. Whether an LLC membership interest has a taxable situs in California involves a facts-and-circumstances inquiry. Such inquiries are traditionally difficult to predict. Moreover, searching for an answer involves a type of residency nexus. California is notorious for taking strident positions concerning residency, and this determination may be particularly subjective.

The general rule under Revenue and Taxation Code Section 17952 is that income from the sale of stocks, bonds, notes or other intangible property is not considered to be derived from California sources unless the intangible property "acquired a business situs in this State ... ." Section 17952 also provides the exception to that rule, that:

> if a nonresident buys or sells such property in this State or places orders with brokers in this state to buy or sell such [intangible] property so regularly, systematically, and continuously as to constitute doing business in this State, the profit or gain derived from such activity is income from sources within this State irrespective of the situs of the property.

Regulations promulgated under Section 17952 further clarify that intangible personal property can acquire a business situs in California if it is employed as capital in California, or if the:

> possession and control of the [intangible] property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State.

Pledging an interest as security for a debt? Beware. Regulation 17952(c) provides that if a nonresident pledges intangible personal property in California as security to pay indebtedness or taxes, that intangible personal property acquires a business situs in California. Similarly, according to Regulation 17952(c), the

California bank account of a nonresident's branch office has a business situs in California.

Interestingly, a California appellate court case, *Milhous v. Franchise Tax Bd.*, 131 Cal. App. 4th 1260 (2005), contains no discussion about what it means to pledge a security interest in California. Regulation 17952(c) states that "if a nonresident pledges stocks, bonds or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here."

Examples Where Intangibles Acquired California Situs

In *Holly Sugar Corp. v. Johnson*, 18 Cal. 2d 218 (1941), a New York corporation with its principal office in Colorado was engaged in the principal business of growing sugar beets and marketing and refining sugar. Holly Sugar purchased 70 percent of the outstanding stock of a California corporation, which also had as its principal business growing sugar beets and marketing and refining sugar. The California Supreme Court stated that:

> Business situs arises from the act of the owner of the intangibles in employing the wealth represented thereby, as an integral portion of the business activity of the particular place, so that it becomes identified with the economic structure of that place, and loses its identity with the domicil[e] of the owner.

The court explained that the mere purchase of a majority interest in the total outstanding stock of the California corporation was not enough to "satisfy the test of integration essential to an assignment of business situs to corporate stock." At least that was good news.

Unfortunately, though, the facts showed that Holly Sugar (a New York corporation) had not merely made a passive investment in the California corporation. Rather, it purchased the stock of the California corporation with the object of controlling its business operations and using it as a mere adjunct, agency or instrumentality of the New York corporation in the conduct of its unitary business. Therefore, that "organic unity of operation" gave the New York corporation a California business situs in the corporate stock.

A California SBE opinion, *International Health Institute, LLC*, Case No. 305199, provides an example in which an LLC membership interest acquired a California business situs. *International Health Institute, LLC* involved a single-member Nevada LLC. It filed a 1999 California LLC return and paid the $800 annual LLC tax.

However, International Health subsequently amended its 1999 return, indicating that it was not doing business in California and therefore did not owe the $800 annual LLC tax for 1999. International Health's sole member and manager was a California resident. The company used the California business address for tax filings and had a California tax professional prepare its returns.

Moreover, International Health owned interests in other LLCs and partnerships engaged in investment businesses in California (real estate sale and rentals). International Health contributed capital to California LLCs during 1999. The California Franchise Tax Board (FTB) argued that the sale of securities or of interests in LLCs or partnerships within California constituted doing business in California. Moreover, the FTB argued that performing managerial functions in California constituted doing business in the state.

Predictably, the FTB noted that International Health's sole member and manager was a California resident. The SBE explained that *doing business* in California can include actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. Indeed, it can include the purchase and sale of securities. However, the SBE noted that doing business in California would *not* include the mere receipt of dividends and interest in the corresponding distribution of that income to shareholders.

Ultimately, the SBE determined that International Health was doing business in California in 1999. Key factors were the company's purchase of interests in California LLCs and partnerships during 1999 and the fact that its sole member presumably conducted business on International Health's behalf in California. Therefore, it was subject to California's annual LLC tax.

Examples Where No California Situs

Despite these examples, the SBE has acknowledged that the sale of a limited

partnership interest "is taxable by the domicile of the limited partner unless the limited partnership interest had acquired a business situs in California." Thank heaven! In some cases, the SBE has actually found that such an interest has *not* acquired a business situs in California.

In *Appeal of Amyas and Evelyn P. Ames*, 87-SBE-042, available at www.boe.ca.gov/legal/pdf/87-sbe-042.pdf, a limited partnership formed under Missouri law had a principal business activity concerning real property located in Los Angeles, California. The general partners were located in California and filed all the appropriate partnership documents with California state agencies, including California partnership returns. While the partnership was in existence, the limited partners did not pay any California taxes because rental income from the property was offset by accelerated depreciation.

In 1973, the Los Angeles real estate in the entity encountered severe financial difficulties leading to a foreclosure in 1974. Just prior to the foreclosure, several limited partners sold their limited partnership interests to the general partners. There were gains as a result of the reduction in those limited partners' bases in their respective partnership interests caused by the allocated partnership losses from accelerated depreciation taken in prior years.

After 1974, the California FTB contacted the limited partners. The FTB demanded that they file California returns in connection with the sale of their limited partnership interests. The limited partners took the position that the sale of their limited partnership interests was a sale of intangible personal property and thus not taxable in California but rather in their home states.

Thus, that gain from the sale should be taxed in their respective states of domicile, not California. However, the FTB argued that those limited partnership interests acquired a business situs in California. In support, the SBE cited Revenue and Taxation Code Section 17952 and *Holly Sugar*.

There are situations in which intangible property can acquire a business situs in California. Examples evidently include pledging the intangible interest as security for debt or somehow employing the intangible as an integral portion of the business activity in a particular place so that it becomes identified with the place's economic structure. Of course, that sounds amorphous.

Fortunately, though, in *Appeal of Amyas and Evelyn P. Ames*, the SBE concluded that the limited partners had made no attempt to localize their limited partnership interests in California. Undaunted, the FTB then argued that since the very operation of the partnership tied each limited partnership's interests to California, those interests had acquired a business situs in California. Fortunately, again, the SBE sided with the non-Californians.

The SBE rejected the FTB's argument, explaining that the gain did not result from partnership operations, but from the limited partners' sale of their partnership interests. Fundamentally, the SBE ruled, that was the sale of intangible property. The limited partners made no effort to employ the wealth represented by the intangibles so as to integrate them into business activities in California. Accordingly, those intangibles did not acquire a business situs in California.

The Nuances of Nexus

Interestingly, the SBE referenced *Appeal of Amyas and Evelyn P. Ames* in a 2000 SBE opinion, *Bruce E. Colegrove*, Case No. 32604. That too is an interesting case. It considered whether income derived from a partnership's operation of an apartment building in California and the subsequent sale of the building constituted California-source income to a nonresident partner.

The SBE determined that income from the sale of the apartment building (a partnership asset) would be California-source income. The SBE referred to *Appeal of Amyas and Evelyn P. Ames* for contrast. Indeed, the SBE noted that unlike pass-through income from a partnership, the sale of a partnership interest could give rise to capital gain income. That would be sourced to the seller's state of residence.

The California appellate court case of *Valentino v. Franchise Tax Bd*, 87 Cal. App. 4th 1284 (2001), specifically concerned the source of pass-through income of an S corporation. In that decision, the appellate court explained a similarity between nonresident S corporation shareholders and nonresident partners. Each may only be taxed by California to the extent the income claimed to be subject to tax is fairly

attributable to S corporation or partnership activities in California.

The appellate court explained that Revenue and Taxation Code Section 17952 provides the general rule. Income from intangible property is not sourced to California, unless the intangible property requires a business situs in California. Yet that rule does not apply to an S corporation shareholder's share of S corporation income, unless that corporate income is *itself* derived from intangibles.

The SBE relied heavily on the *Valentino* decision in a 2003 opinion, *Venture Communications, Inc.*, Case No. 141641; *Roberto Brutocao*, Case No. 140415, 2003 Cal. Tax LEXIS 31 (2003). This is a complex and messy case, but the salient facts are worth noting. An individual Nevada resident (Brutocao) owned shares in a California C corporation (Venture). Venture was also a limited partner in a California partnership (Falcon Cable TV of West Covina).

As a consequence of a lawsuit, the general partner of Falcon Cable purchased Venture's limited partnership interest in Falcon Cable from Venture. Venture subsequently elected S corporation status. As a result, the FTB taxed the individual Nevada resident (Brutocao) on his share of Venture's S corporation income. The FTB said this constituted California-source income.

On appeal, the SBE discussed the two-step analysis employed in *Valentino*. First, characterize the shareholder's S corporation income by reference to the corporate-income-producing activity. Thus, with an S corporation, a shareholder's proportionate share of income is determined as if the income were derived directly from the S corporation's source of income (not from the shareholder's stock).

Second, once the source of income is characterized, the shareholder should source the items of income according to the particular sourcing rule that applies to each item. Applying this two-step analysis, the SBE determined that Brutocao's source of income was from Venture's sale of its limited partnership interest in Falcon Cable. The SBE noted that the sale of the partnership interest was a sale of intangible personal property.

Next, the SBE sought to apply the proper sourcing rule to that sale of intangible personal property. Citing to *Valentino*, the SBE determined that Revenue and Taxation Code Section 17952 should not apply to a shareholder's share of S corporation income, unless the corporate income itself is derived from intangibles. Hence, the SBE determined that Brutocao was not required to report or pay tax in California on his proportionate share of the Venture S corporation income derived from the sale of its intangible limited partnership interest.

The SBE noted that the limited partnership interest had not developed any business situs in California. After all, Brutocao had not employed that interest in a manner "so as to integrate that interest into the business activities in California." Such conclusions must make many nonresidents of California breathe a sigh of relief. California taxing authorities can occasionally conclude that even their long arms do not reach far enough.

UDITPA

It is also worth addressing Revenue and Taxation Code Section 25125 of the Uniform Division of Income for Tax Purposes Act. Section 25125 addresses how to treat a corporate partner's disposition of a partnership interest. Section 25125(c) states that "[e]xcept in the case of the sale of a partnership interest, capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state." Section 25125(d) then states that:

> Gain or loss on the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold.

The cases discussed above, which did not involve corporate partners, relied on Revenue and Taxation Code Section 17952 (not Section 25125)

for determining when a nonresident's income from intangibles should be sourced to California.

The Facts Matter

These examples of LLC interests and their disposition can be read in several ways. To the appropriately paranoid, they may suggest that California has left itself adequate room to determine, based on the facts, when it believes the sale of an intangible is sufficiently connected to active participation in a business to constitute California-source income. Perhaps that is not even being paranoid.

Of course, the sale of membership interests may be purely a passive-type activity. The almost black letter assumption by many investors and advisers appears to be that partnership and membership interests are intangibles, so the topic addressed here is hardly a serious one. Perhaps.

But for the "these-are-only-intangibles and can't be taxed by California" argument to succeed, the membership interests cannot have established a business situs in California. Is having a membership interest pledged as security for debt in California enough? Be careful.

Furthermore, the liquidation of a partnership (which presumably would be viewed the same as the liquidation of an LLC) can be seen as the termination of the partnership's entire partnership interest. Unlike a sale or exchange, a liquidation can involve the imposition of distribution rules concerning partnership property, and that can invoke—surprise, surprise—the topics of California filing and withholding.

California Filing

LLCs doing business in California, organized in California, organized in another state but registered with California's Secretary of State, or having income from California sources file a California FTB Form 568. LLCs that elect to be taxed as a corporation for federal income tax purposes do not file a Form 568.

Nonregistered foreign LLCs that are not doing business in California, but that derive income from California, utilize a Form 565 (California's partnership return). However, for purposes of determining whether to file Form 565 or 568, nonregistered foreign LLCs that are members of an LLC doing business in California are considered to be doing business in California. Therefore, those nonregistered foreign LLCs must file a Form 568.

Multiple-member LLCs (but not single-member LLCs) with one or more nonresident members must attach a FTB Form 3832 to Form 568. FTB Form 3832 lists the name and Social Security number, individual taxpayer identification number or federal employer identification number of each nonresident member. FTB Form 3832 also includes a signature for each nonresident member.

That can be a sensitive item for anyone to sign. After all, it grants consent to California to tax that member's distributive share of LLC income attributable to California sources. Specifically, the consent states that:

> I consent to the jurisdiction of the State of California to tax my distributive share of the LLC income attributable to California sources.

California Withholding

According to California Regulation 18662-1, certain persons in control, receipt, custody, disposal or engaged in payment of income of a character described in Regulation 18662-2 must withhold taxes to be paid to the FTB. Those withholding agents include individual residents, partnerships and corporations—and presumably also LLCs.

Regulation 18662-1 states that persons subject to withholding requirements must withhold taxes if they are in control, receipt, custody, disposal or payment of income of the character described in Regulation 18662-2 and derived from California sources by "individuals who are nonresidents ... ." This language may be unclear as to whether withholding is required for payments of California-source income to LLCs who are nonresidents.

Maybe, but California's *Nonresident Withholding Allocation Worksheet* (Form 587) explains that "payments made to nonresident vendor/payees (including individuals, corporations, partnerships, LLCs, estates, and trusts) are subject to withholding." Hence, reporting apparently applies to payments made to nonresident LLCs.

Under Regulation 18662-2, the items subject to withholding include "interest, dividends, rent, prizes and winnings, premiums, annuities, emoluments, compensation for personal

services, and other fixed or determinable annual or periodical gains, profits and income." Furthermore, Regulation 18662-2 instructs that withholding at the source is required for "the case of rentals or royalties for the use of, or for the privilege of using in this State, patents, copyrights, secret processes and formulas, good will, trademarks, brands, franchises, and other like property of such intangible property having a business or taxable situs" in California.

Whether this reference to "intangible property" extends to the sale of an intangible LLC membership interest that has a taxable situs in California is unclear. On the other hand, California FTB Form 587 states that withholding is not required for payments to nonresidents of income from intangible personal property, such as interest and dividends, unless that intangible property has acquired a business situs in California.

If an LLC fails to attach a Form 3832 or to withhold tax from payments of California-source income to a nonresident member, who pays? You guessed it. The amount the LLC fails to withhold will be considered a tax of the LLC subject to penalties under Revenue and Taxation Code Section 19132 and interest under Section 19101 for failure to timely pay the tax.

Section 19132 of California's Revenue and Taxation Code imposes a five-percent penalty on the total tax paid plus a 0.5-percent-per-month penalty on any remaining tax unpaid. Section 19101's interest rate is determined based on whatever the current federal short-term rates are for overpayment and underpayment, plus an additional two or three percentage points depending on whether the penalized entity is a corporation.

Be Afraid?

This discussion of California tax law has focused on a rather narrow set of circumstances and concerns. More globally, of course, businesses (both foreign and domestic) that tiptoe into California will want to look at the whole Golden State tax landscape. Should non-California individuals, LLCs, partnerships and corporations be afraid of California? No, but they should be very cautious. As my father used to say: don't trust anyone who isn't family, and keep a close eye on them.

Article Submission Policy

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