

We created this guide to address advertisements that promise big tax savings to businesses that form outside of California. Some tax-planning advisors and promoters encourage businesses, many of which operate only in California, to form in a state which levies no income or franchise tax, such as Nevada. While it's sensible for some multistate businesses to form elsewhere, we believe some promoted services could mislead business entities doing business in California. These entities could fail to file returns and pay taxes as required.

Where a business entity actually is doing business determines how it is taxed. Many promoters charge setup or service fees to maintain an out-of-state address, telephone, fax, and receptionist service.

What they don't tell you is, if your business performs any business activities in California, your business is subject to California tax and filing requirements regardless of where the business is organized or incorporated.

Doing Business in California

Beginning with the 2011 tax year, a business entity is considered to be doing business in California if any of the following apply:

- The entity actively engages in any transaction in California for the purpose of financial gain or profit.
- The entity is organized or commercially domiciled in California. A business is commercially domiciled in California if the principal place from which the trade or business of the entity is directed or managed is in this state.
- The entity's California sales exceed either \$500,000 (annually adjusted for inflation) or 25 percent of their total sales. Sales include sales made by an agent or independent contractor of the entity.
- The entity's California real property and tangible personal property exceeds either \$50,000 (annually adjusted for inflation) or 25 percent of their total real property and tangible personal property.

- The entity's California compensation paid exceeds either \$50,000 (annually adjusted for inflation) or 25 percent of the total compensation paid by the entity.

For the above tests, the sales, property, and payroll of the entity include their pro rata or distributive share of the sales, property, and compensation of pass-through entities. "Pass-through entities" means a partnership, a limited liability company (LLC) classified as a partnership for federal income tax purposes, or a corporation that has elected to be classified as an "S corporation" for federal income tax purposes.

An entity is considered to be actively engaging in a transaction in California for financial gain or profit if any of its members, managers, or other agents conducts business in California on behalf of the entity, regardless of where the entity primarily conducts business. Accordingly, it will be subject to applicable California taxes and filing requirements.

Example:

Paul is a California resident and a member of an LLC that is legally organized in Nevada. The Nevada LLC owns property in Nevada. The LLC hires a Nevada management company to collect rents and provide maintenance. Paul has the right to hire and fire the management company. He occasionally has telephone discussions with the management company regarding the property. He is ultimately responsible for the property and oversees the management company. Paul, therefore, is actively engaging in transactions for financial profit in California on behalf of the LLC. The LLC is doing business in California and must file Form 568 and pay the applicable annual tax.

As you can see, it does not take much California activity for your entity to be considered doing business in California and subject to California tax, regardless of where it is organized or incorporated. In addition, California has an annual minimum \$800 tax requirement. Even if your business entity does not have California-sourced income (and does not have gross receipts assignable to California for purposes of the LLC annual graduated fee), if it is found to be "doing business" under

the rules above, a tax return and the minimum \$800 annual tax are still due.

California Tax

If your business entity is doing business in California, or receives income from California sources, it is subject to applicable California taxes. A business entity is subject to any applicable entity tax if its business is conducted in California by its managers, directors, or other persons acting as its agents. In addition, a business entity may be subject to California tax when it has an ownership interest in one or more business entities that are doing business in California.

Entities engaged in a multistate business that includes business within California, or which have income from sources both within and outside California, must apportion and allocate their income to each state and pay the required taxes. When two corporations are engaged in a single business, the business is unitary. This means we view all of the activities comprising the single trade or business as one unit regardless of whether those activities are conducted by divisions of a single corporation or by multiple commonly owned and controlled corporations. For purposes of California corporate tax, the business income from the unitary business activities is combined and apportioned to the states where the business is conducted. Each corporation that is doing business in California is then separately subject to California income or franchise tax on its share of the unitary business income apportioned to California. Accordingly, even if a business entity incorporates in a state other than California and maintains an address outside California, as long as that business entity is doing business in California, or one of the entity's unitary affiliates is doing business in California, the unitary group (through one or both of those entities) will be subject to the California income and franchise tax. Nonbusiness income is allocated according to nonbusiness income sourcing rules. For more details about the requirements relating to taxation of multistate businesses, see Schedule R and FTB 1061, and Forms 565, 568, 100, or 100S, as applicable.