State of California
Franchise Tax Board

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01.11.11

LEGAL RULING 2011-01

Subject: Activities of a Disregarded Entity

ISSUE

Is the sole owner of a disregarded entity "doing business" in California if the owner has no other activities in the State other than those of its disregarded entity?

FACTS

A business may operate under any number of legal forms. Among available choices are certain disregarded entities, including a Qualified Subchapter S Subsidiary ("QSub") and a Single Member Limited Liability Company ("SMLLC").[1]

SITUATION 1

"A" is a QSub, which was validly formed under the laws of a state other than California, which has not registered to do business in California, and which has activities in California sufficient to constitute "doing business" within California. The owner of A ("X") is a corporation validly formed under the laws of a state other than California, which has made a proper election to be treated as an S corporation, and which has made the election under Internal Revenue Code ("IRC") section 1361(b)(3) to treat A as a QSub.[2] X has no separate activities in California sufficient to constitute "doing business" within California. X fails to file the California franchise tax return required for Owner.

The Franchise Tax Board ("FTB") determines that X is "doing business" in California due to the activities of A, and assesses tax, interest, and a penalty for failure to file a franchise tax return. X asserts California has no legal authority to tax X because X has not established nexus with California. X further asserts the activities of A do not create nexus with California for X.

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[1] While the factual situations in this Legal Ruling only address a QSub and an SMLLC that is disregarded for income and franchise tax purposes, the legal concepts discussed are equally applicable to any other disregarded entity.

[2] The corporation may be an incorporated entity, or an eligible business entity such as a limited liability company that has checked-the-box to be classified as a corporation for income and franchise tax purposes, which has made an election under Subchapter S of the Internal Revenue Code to be classified as an S corporation. A may be owned directly by X, or A may be owned by X via another disregarded entity owned by X.

SITUATION 2

"B" is an SMLLC, which was validly formed under the laws of a state other than California, which has not registered to do business in California, and which has activities in California sufficient to constitute "doing business" within California. The sole owner of B ("Y") is a corporation validly formed under the laws of a state other than California.[3] B is disregarded as an entity separate from its sole owner, Y, for federal and California income and franchise tax purposes. Y has no separate activities in California sufficient to constitute "doing business" within California. Y fails to file the California franchise tax return required for Owner.

The Franchise Tax Board ("FTB") determines that Y is doing business in California due to the activities of B, and assesses tax, interest, and a penalty for failure to file a franchise tax return. Y asserts California has no legal authority to tax Y because Y has not established nexus with California. Y further asserts the activities of B do not create nexus with California for Y.

SITUATION 3

Same facts as Situation 2, except, since B is subject to an annual tax imposed on Limited Liability Companies ("LLCs") that are not classified as a corporation and, where appropriate, a fee, B files an annual California LLC Return of Income, B does not include the signed form of consent statement for its owner, Y. FTB assesses tax, penalties, and interest upon Y for failure to file a California franchise tax return. In addition to the arguments made by Y in Situation 2, Y also asserts California has no legal authority to tax Y because Y has not consented to be taxed by California.

LAW AND ANALYSIS

California franchise tax law provides that every corporation "doing business" within the limits of this State and not expressly exempt from taxation shall annually pay a franchise tax according to or measured by its net income, or, if greater, the minimum tax."[4]

Federal law, as reflected in the IRC and federal regulations, identifies QSubs and check-the-box entities (such as an SMLLC), among others, as legally recognized entities with one owner that may be disregarded as separate from their owners for federal income tax purposes.[5] California tax law conforms to federal law regarding classification of business

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[3] The corporation may be an incorporated entity, an eligible business entity, such as a limited liability company that has checked-the-box to be classified as a corporation for income and franchise tax purposes, and/or a corporation that has made an election under Subchapter S of the Internal Revenue Code to be classified as an S corporation. B may be owned directly by Y, or B may be owned by Y via another disregarded entity owned by Y.

[4] See Cal. Rev. & Tax. Code §§ 23151, 23181. Note, all section references in this Legal Ruling are to the California Revenue and Taxation Code unless otherwise specified.

[5] Int.Rev. Code § 1361, and Treas. Reg. §§ 301.7701-2(a) and -3.

entities, and specifically mandates that federal and California entity classification be the same.[6]

One important distinction between California and federal law is found in subdivision (a)(2) of Section 23800.5, which specifies *"activities"* of a QSub "shall be treated as activities (including activities for purposes of Section 23101)...of the "S corporation."[7]

Therefore, by application of subdivision (a)(2) of Section 23800.5, if a QSub has activities sufficient to constitute "doing business" in the State, the QSub owner is "doing business" in California and therefore must pay a franchise tax or the minimum tax, whichever is greater.

In the case of an SMLLC, federal and California regulations allow the SMLLC to elect how the SMLLC will be taxed for income/franchise tax purposes. Specifically, the SMLLC may elect (1) to disregard the SMLLC's status as an entity separate and distinct from its owner, or (2) to have the SMLLC classified as an association taxable as a corporation.[8] If the SMLLC does not make an affirmative election, the default treatment under the Treasury Regulations is to disregard the SMLLC's status as an entity separate and distinct from its owner.[9]

If the separate entity status of the SMLLC is disregarded for income/franchise tax purposes, the activities of the SMLLC are treated in the same manner as a sole proprietorship, branch, or division of the owner.[10] Thus, if the SMLLC is owned by a corporation, the activities of the SMLLC are treated in the same manner as the activities of a branch or division of the corporate owner. If the activities of a branch or division are sufficient to be considered "doing business" in California, those activities are sufficient to treat the corporate owner as "doing business" in California.[11]

For an SMLLC treated as a disregarded entity for income/franchise tax purposes, the legal result is that the SMLLC's activities, which are sufficient to establish that SMLLC is "doing business" in California, are treated as the activities of its owner, and the owner is thereby "doing business" in California.

Consequently, where a QSub's or other disregarded entity's (including an SMLLC) activities constitute "doing business" in California, the owner is "doing business" in California.

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[6] See e.g., Cal. Rev. & Tax. Code §§ 23038, subd. (b)(2)(B)(iii), 23800, and 23800.5; Int.Rev. Code § 1361; and Treas. Reg. §§ 301.7701-2(a) and -3. The only situation in which a business entity may be classified differently for California purposes is the situation covered in Cal. Code Regs., tit. 18, § 23038(b)-3(b)(4).

[7] Cal. Rev. & Tax. Code § 23800.5(a)(2)(B).

[8] See Treas. Regs. § 301.7701-3(a); Cal. Code Regs., tit. 18, § 23038(b)-2(a)). See also *Britton v. Shulman* (1st Cir. 2010) 106 A.F.T.R.2d 6048, affg. *Medical Practice Solutions LLC, Carolyn Britton, Sole Member v. Commissioner* (March 31, 2009) 132 T.C. 125; *McNamee v. Dept. of the Treas.* (2nd Cir. 2007) 488 F.3d 100; and *Littriello v. U.S.* (6th Cir. 2007) 484 F.3d 372.

[9] *Ibid*.

[10] See Treas. Regs. § 301.7701-2(a); Cal. Code Regs., tit. 18, § 23038(b)-2(a).

[11] See, e.g., Appeal of Atlantic, Gulf and Pacific Company of Manila, Inc., 82-SBE-255 (Nov. 17, 1982) [Activities of Taxpayer's machinery sales division in California sufficient to create nexus to impose California franchise tax].

HOLDING – SITUATION 1 & 2

Since A and B are disregarded entities for federal income tax purposes, they are also disregarded for California income/franchise tax purposes. As discussed above, the activities of A and B are the activities of X and Y, respectively. If the activities of A or B constitute "doing business" in California, X and Y are also "doing business" in California due to their ownership of the disregarded entities. As a result of "doing business" in California, X and Y have substantial nexus with California. X and Y are therefore required to file a California franchise tax return as provided within the California Revenue and Taxation Code and related regulations, pay the associated tax, and are subject to penalties and interest for failure to do so.[12]

HOLDING – SITUATION 3

FTB Form 568-LLC Return of Income includes a section specifically for an SMLLC which is a disregarded entity. If the consent section is not signed by the owner, the SMLLC is required to pay on behalf of the owner an amount equal to the highest marginal rate prescribed for the owner multiplied by the amount of the California source income reflected on the SMLLC's return for the taxable period.[13]

FTB Form 568 provides the consent statement for non-resident owners of LLCs that are disregarded, solely as a collection mechanism. The consent statement does not alter the legal determination of whether an owner of a disregarded entity is "doing business" in California as a result of an ownership interest in such entity. The consent is merely a matter of administrative convenience. As a result, withholding such consent may never operate, as a matter of law, to sever taxable nexus of the owner of the disregarded entity with California.[14]

As discussed under the Holding in Situation 2, Y has substantial nexus with California. Withholding consent on FTB Form 568 does not operate to sever Y's nexus with California.[15] As a result, since B is an SMLLC that is disregarded for California income and franchise tax purposes, Y is required to file a California franchise tax return, as provided within the California Revenue and Taxation Code and related regulations, pay the associated tax, and is subject to penalties and interest for failure to do so.[16]

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[12] If Y was one of certain other legal business entities (e.g. LLC, limited partnership, limited liability partnership), the activities of B would also be attributed to Y, and Y would similarly have an obligation to file the corresponding Return of Income or other California tax return.

[13] See Cal. Rev. & Tax. Code § 18633.5(i)(1)-(4).

[14] See *Valentino v. Franchise Tax Bd.* (2001) 87 Cal. App. 4th 1284, 1293 (finding consent meaningless in the context of constitutional ability to tax California source income); see also *Meyer v. Charnes* (Colo. Ct.App. 1985) 705 P.2d 979, 983; and *Kulick v. Dept. of Rev.* (1980) 290 Ore. 507 (sustaining taxation of distributions to S corporation nonresident shareholders).

[15] The same result would occur under Situation 1 if A (QSub) were owned by an SMLLC, treated as a disregarded entity, which was owned by X either directly or indirectly owned via another disregarded entity.

[16] As noted in Footnote 10, if Y was one of certain other legal business entities (e.g. LLC, limited partnership, limited liability partnership), the activities of B would also be attributed to Y, and Y would similarly have an obligation to file the corresponding Return of Income or other California tax return.

DRAFTING INFORMATION

The principal authors of this ruling are Michael D. Vigil and William Gardner of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Vigil, and/or Mr. Gardner, at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720.