



July 14, 2016

LEGAL RULING 2016-01

SUBJECT: Calculation of the Limited Liability Company Fee – Real Property Held for Sale to Customers in the Ordinary Course of Business

ISSUE

For purposes of calculating the limited liability company (“LLC”) fee pursuant to California Revenue and Taxation Code (“RTC”) section 17942, does cost of goods sold include the adjusted basis of real property held for sale to customers in the ordinary course of business?

SITUATION ONE

X is a California LLC with two or more members that is classified as a partnership for federal and California income tax purposes. X holds real property for sale to customers in the ordinary course of its trade or business. X owns Blackacre, a parcel of unimproved real property, for sale to customers in the ordinary course of its trade or business, and sells Blackacre during its 2016 taxable year.

SITUATION TWO

Assume the same facts as in Situation One, except that instead of selling Blackacre, X sold Whiteacre, a parcel of unimproved real property held by X for investment purposes, during its 2016 taxable year.

LAW AND ANALYSIS

RTC section 17942 imposes a fee on LLCs based on "total income from all sources derived from or attributable to this state". Total income for purposes of calculating the LLC fee is defined in RTC section 17942, subdivision (b)(1)(A), as "gross income, as defined in Section 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer." Therefore, the cost of goods sold is added back to gross income so that the LLC fee for such amounts is essentially calculated based on net gross receipts.

The LLC fee was originally enacted as part of comprehensive LLC authorizing legislation in Senate Bill (“SB”) 469 (Ch. 1200, Stats. 1994). The legislative history of SB 469 demonstrates that the term "cost of goods sold" was intended to include the adjusted basis of real property held for sale to customers in the ordinary course of business. Originally, SB

469 had a flat \$800 LLC tax which resulted in SB 469 being scored as a revenue loss.¹ The Legislature then added a graduated LLC fee to the draft bill in order to make SB 469 revenue neutral.² An August 1993 fiscal impact analysis was performed to determine whether the graduated LLC fee made the draft SB 469 revenue neutral. The original version of the graduated LLC fee was based on and used the term “gross receipts”.³ However, the August 1993 fiscal impact analysis was calculated based on information readily collectible from tax returns, which included (1) gross receipts from an LLC's ordinary trade or business income, and (2) gross income amounts for other items of income, such as gains from investments. More specifically, the August 1993 fiscal impact analysis was based on total income (for example, line 8 of the 1993 California Form 565) with cost of goods sold (for example, see line 2 of the 1993 California Form 565) added back so that the LLC fee for trade or business income was based on gross receipts (for example, see line 1(c) of the 1993 California Form 565) and other income was based on gross income. As a result, the Legislature used the term “cost of goods sold” in SB 469 as a means to ensure the LLC fee calculation would be based on gross receipts for income from an LLC's ordinary trade or business, and other items of income would be based on gross income.⁴ In this regard, the use of “cost of goods sold” was based on how amounts are reported on tax returns, with the result that the LLC fee for ordinary trade or business income is based on gross receipts. Therefore, the legislative history of SB 469 demonstrates that the Legislature intended the LLC fee be based on gross receipts for the ordinary trade or business income of all LLCs, including those LLCs that held real property for sale to customers in the ordinary course of their trade or business.

While the above analysis demonstrates the Legislature's intent that the LLC fee be based on gross receipts for all LLCs, including dealers in real property, it is also notable that the term “cost of goods sold” in the context used by the Legislature included real property. The August 1993 fiscal impact analysis and subsequent Calculation of the Adjustment to the Limited Liability Company Fees divided data into four general categories: Manufacturing, Real Estate, Services and Other.⁵ In calculating the LLC fee, cost of goods sold was added back to all four categories, including the “Real Estate” category. Cost of goods sold in the “Real Estate” category included real property as the term “cost of goods sold” on California entity tax returns for “Real Estate” businesses included real property. For example, line 2 of the 1993 California Form 565 was based on and directly referred to IRS Form 1065. IRS Form 1065's use of cost of goods sold included real property. Both the form and the instructions to IRS Form 1065 state that costs of goods sold include costs capitalized under Internal Revenue Code (“IRC”) section 263A, with the instructions to IRS Form 1065 stating that “[t]he uniform capitalization rules of section 263A require partnerships to capitalize or include in inventory certain costs incurred in connection with the production of real and personal tangible property held in inventory or held for sale in the ordinary course of

¹ SB 469, as introduced February 25, 1993 and amended April 12, 1993.

² SB 469, as amended September 10, 1993.

³ SB 469, as amended September 10, 1993.

⁴ SB 469, as amended January 3, 1994.

⁵ See August 1993 fiscal impact analysis, August 9, 1994 “Methodology for the Limited Liability Company Fee Adjustment Calculation,” and “Calculation of the Adjustment to the Limited Liability Company Fees” for 1999, 2000 and 2001 dated January 1999, December 1999, and December 2000, respectively.

business."⁶ See also IRC section 263A(b) which states that the section applies to real property produced by the taxpayer and real property which is acquired by the taxpayer for resale.

As discussed above, the legislative history of SB 469 is clear that the LLC fee was (1) meant to be based on gross receipts for ordinary trade or business income, and (2) the Legislature properly included real property in the term "cost of goods sold" as a means to ensure the LLC fee calculation would be based on gross receipts for ordinary trade or business income.

Similar to the Legislature's use of the term "cost of goods sold" to include real property for purposes of the LLC fee under SB 469, near in time to the enactment of SB 469, Congress also used the term "cost of goods sold" to include real property. See IRC section 199, which was enacted as part of the American Jobs Creation Act of 2004 (P. L. 108-357, sec. 102(a), 118 Stat. 1424). IRC section 199 "give[s] domestic manufacturers a tax deduction for certain domestic production activities."⁷ IRC section 199 specifically uses the term "cost of goods sold"⁸ in connection with "construction of real property performed in the United States by the taxpayer in the ordinary course of such trade or business".⁹ Similarly, the Treasury Regulations promulgated under IRC section 199 directly state that the cost of goods sold includes both inventory and non-inventory property. Treasury Regulation section 1.199-4(b) states, in relevant part, that "[i]n the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) of non-inventory property, CGS [cost of goods sold] for purposes of this section includes the adjusted basis of the property." See also *Gibson & Assocs. v. Commissioner*,¹⁰ wherein the Tax Court applied the deduction under IRC section 199 to a taxpayer whose business was construction of real property.

It is noteworthy that Congress gave the IRS discretion to determine when to use inventories for purposes of IRC section 471.¹¹ While the IRS chose to exclude real property from the term "inventory" for purposes of IRC section 471, Congress, the IRS and courts do include real property in the term "cost of goods sold," even at the same time real property is excluded from inventory.¹² The term "cost of goods sold" is thus used in a broader sense than the term "inventory." For example, the Ninth Circuit and Tax Court in *Homes by Ayres v. Commissioner*¹³ determined that while real property was not included in inventory, the

⁶ See the 1993 Instructions for Form 1065, page 10. See also the 1993 Instructions for Form 1065, page 13, instructing that Form 1065, Schedule A regarding cost of goods sold includes costs under IRC § 263A which, as discussed in the legal ruling, includes the cost of real property sold by dealers.

⁷ *Gibson & Assocs. v. Commissioner* (2011) 136 T.C. 195, 222.

⁸ IRC § 199(c)(1)(B)(i).

⁹ IRC § 199(c)(4)(A)(ii).

¹⁰ *supra*, 136 T.C. 195.

¹¹ See IRC § 471. See also *W. C. & A. N. Miller Dev. Co. v. Commissioner* (1983) 81 T.C. 619, 626 and *Homes by Ayres v. Commissioner* (9th Cir. 1986) 795 F.2d 832, 835.

¹² See *Homes by Ayres v. Commissioner*, *supra*, 795 F.2d 832, 836, where the Ninth Circuit acknowledges that real property could be included in inventory for accounting purposes but the IRS still has discretion to determine inventory for tax purposes with the Ninth Circuit stating that "[t]he fact that financial accounting standards have progressed does not mean that taxpayers have a right to inventory accounting methods for tax purposes."

¹³ *Homes by Ayres v. Commissioner*, *supra*, 795 F.2d 832, and *Homes by Ayres v. Commissioner* (1984) T.C. Memo 1984-475.

courts still used the term “cost of goods sold” to refer to the cost of the real property sold (which the courts referred to as "cost of sales" and "cost of homes sold"). The Tax Court in *Homes by Ayres* noted that the issue was whether the taxpayer could use an inventory method to calculate the cost of homes sold, with the court stating that "[t]he issue for decision is whether petitioners, as builders and sellers of residential real estate, were entitled to adopt the LIFO (last-in-first-out) method of accounting for the cost of homes sold."¹⁴ The usage of “cost of goods sold” in this context demonstrates that cost of goods sold refers to the cost of property sold, regardless of whether or not it qualifies as “inventory” under IRC section 471. Similarly, in *W. C. & A. N. Miller Dev. Co. v. Commissioner*,¹⁵ the IRS distinguished between inventory and cost of goods sold in their notice of deficiency, which stated that “[i]t is determined under the provisions of sections 446, 471 and 472 of the Internal Revenue Code that you, as a real estate company, may not use the LIFO method of inventory in computing your cost of goods sold.” In regard to IRC section 199, the Treasury Regulations specifically discuss the calculation of cost of goods sold for "non-inventory property".¹⁶

Courts similarly use the term "cost of goods sold" to mean the cost associated with property held for sale to customers in the ordinary course of business, including real property. In a case dealing with a real property dealer's sale of real property, the U.S. Supreme Court used the term "gross profit," which is associated with cost of goods sold. See *Colony, Inc. v. Commissioner*¹⁷ in which the U.S. Supreme Court stated that "the deficiencies were based upon the Commissioner's determination that the taxpayer had understated the gross profits on the sales of certain lots of land for residential purposes as a result of having overstated the ‘basis’ of such lots by erroneously including in their cost certain unallowable items of development expense." Similarly, in discussing *Colony* in 2000, the Tax Court directly used the term "cost of goods sold." See *CC&F W. Operations Ltd. Pshp. v. Commissioner*¹⁸ which states that "[a]ll of the receipts of a sale of real property had been disclosed, but cost of goods sold had been overstated." See also *Merlo Builders, Inc. v. Commissioner*¹⁹ where the court stated that “[w]e conclude, after detailed examination of the entire record as applicable to this issue, that petitioners have established by a preponderance of the evidence that the amounts involved represent bona fide accrued real estate costs and are allowable additions to the costs of goods sold.”

Another line of inventory cases deals with the issue of whether materials used in connection with services, including to build real property, are "inventory." In these cases, while the courts held that the materials were not "inventory," these material costs were still referred to as “cost of goods sold.” For example, in *RACMP Enters. v. Commissioner*,²⁰ the court noted that “petitioner reported gross receipts of \$1,564,045, which derived solely from the construction, placement, and finishing of foundations and flatwork. Petitioner reported as

¹⁴ *Homes by Ayres v. Commissioner, supra*, (1984) T.C. Memo 1984-475.

¹⁵ *supra*, 81 T.C. 619, 625.

¹⁶ See Treas. Reg. § 1.199-4(b).

¹⁷ (1958) 357 U.S. 28, 30.

¹⁸ (2000) T.C. Memo 2000-286.

¹⁹ (1964) T.C. Memo 1964-34.

²⁰ (2000) 114 T.C. 211, 218.

cost of goods sold the total cost of all material used in its construction activity during the taxable year at issue, \$993,777.” In *RACMP*, the IRS had asserted that the taxpayer should have reported its materials as "inventory"; however, the Tax Court rejected the IRS's position and found that the taxpayer's reporting was correct. *RACMP* again demonstrates that a taxpayer can have cost of goods sold for tax purposes even though the taxpayer does not have inventory for tax purposes. If cost of goods sold could not include real property, then Congress, the IRS and the courts, including the U.S. Supreme Court, would have been incorrect in their usage of the term "cost of goods sold" as discussed above.

Accordingly, the term “cost of goods sold” as used by RTC section 17942, subdivision (b)(1)(A), includes real property held for sale to customers in the ordinary course of a trade or business. Therefore, LLCs that are dealers in real property must add the cost of goods sold (based on real property) back to gross income in calculating the LLC fee.

HOLDING - SITUATION ONE

Blackacre is held by X for sale to customers in the ordinary course of its trade or business. Blackacre is sold during X's 2016 taxable year. As a result, X's adjusted basis in Blackacre will be added back to X's gross income for purposes of calculating X's 2016 LLC fee under RTC section 17942.

HOLDING - SITUATION TWO

Since X held Whiteacre for investment purposes, rather than for sale to customers in the ordinary course of its trade or business, X's adjusted basis in Whiteacre will not be added back to X's gross income for purposes of calculating X's 2016 LLC fee under RTC section 17942.

DRAFTING INFORMATION

The principal author of this legal ruling is *Ciro Immordino* of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Immordino at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.