



Requested By: Ronald Maddox
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QUESTION PRESENTED:

***** , a foreign corporation, owns a California limited liability company (LLC). Is ***** , required to submit an Exemption Application and receive a determination in accordance with California Revenue and Taxation Code section 23701 to be exempt from California franchise and income tax?

CONCLUSION

***** , is required to submit an Exemption Application and receive a determination in accordance with California Revenue and Taxation Code section 23701 to be exempt from California franchise and income tax.

ANALYSIS AND DISCUSSION

Facts

***** (hereinafter *****), ***** , is an organization granted exemption from federal income tax in accordance with Internal Revenue Code section 501(c)(2), title holding company. Prior to ***** , ***** was a part owner in ***** . On ***** , ***** purchased the remaining interest and became the sole owner of ***** . For tax purposes, ***** elected to be disregarded as a separate entity and its income and assets are reported directly on the income statement and balance sheet of ***** .

***** LLC receives rental income from property owned and located in ***** , California.

***** has not submitted an application for exemption from California franchise or income tax. ***** has submitted California Exempt Organization Annual Information Returns, Form 199, for ***** .

Law

Franchise and Income Tax Imposed by the California Revenue and Taxation Code

Every corporation doing business within the limits of this state and not expressly exempted from taxation shall annually pay to this state, for the privilege of exercising its corporate franchise within this state, a tax according to or measured by its net income, or, if greater, the minimum tax. (See Rev. & Tax. Code, §§ 23151, 23181.) This tax is known as the franchise tax. "Doing business" is defined as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. (See Rev. & Tax. Code, § 23101.)

Every corporation, domestic or foreign, which is not doing business in this State and not expressly exempt from taxation, but which derives income from sources within this State, or from activities carried on in this State, is subject to an income tax. There is no minimum tax imposed on corporations deriving income from sources within this state. (See Rev. & Tax. Code, § 23501 and Cal. Code Regs, title 18, § 23501.) The tax imposed by section 23501 is known as the corporate income tax.

A foreign corporation, which was a limited partner in a California partnership, was not doing business in California. (See *Appeals of Amman & Schmid Finanz AG et al.*, Cal St. Bd. of Equal., April 11, 1996.)

Limited Liability Company Organization

The Beverly-Killea Limited Liability Act of 1994, California Corporations Code section 17000 et seq., authorizes the creation of LLCs as a recognized entity for businesses in California. The California Corporations Code provides that LLCs will have articles of organization in lieu of articles of incorporation (sections 17050 through 17054), operating agreements in lieu of by-laws (section 17001, subdivision (ab)), and recognizes foreign corporations organized as LLCs (subdivisions 17000(p) and (q)). Subject to any limitations contained in the articles of organization and other applicable laws, an LLC may engage in any lawful business activity, except the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business and shall have all of the powers of a natural person in carrying out its business activities. (See Corp. Code, §§ 17002 and 17003.)

Limited Liability Company Taxation

Neither California nor federal law classifies LLCs as corporations or as partnerships for taxation purposes. However, federal "check-the-box" regulations, incorporated by California for income and taxable years commencing on or after January 1, 1997, allow an LLC to elect classification as a corporation, partnership, or sole proprietorship, for

federal and California tax purposes unless the entity meets certain specifications requiring classification as a corporation. (See Rev. & Tax. Code, § 23038; Cal. Code. Regs., tit. 18, §§ 23038(b)-1 through (b)-3.) Classification of an LLC for California franchise or income tax purposes depends on the LLC's federal classification as a corporation, partnership, or "disregarded entity." The classification elected for federal tax purposes is the same for California tax purposes. (See Rev. & Tax. Code, § 23038; Cal. Code. Regs., tit. 18, §§ 23038(b)-1 through (b)-3.)

An LLC with a single owner may (1) elect to be classified as an association taxable as a corporation, or (2) elect to disregard its status as an entity separate from its owner, treat its activities as a sole proprietorship, branch, or division of the owner, and have its activities included in the tax return filed by the owner. (See Cal. Code. Reg., tit. 18, § 23038(b)-2(a).)

Exemption from California Franchise and Income Tax

Revenue and Taxation Code section 23701 states that organizations which are organized and operated for nonprofit purposes within the specific provisions of one of the sections 23701a through 23701z, or are defined in section 23701h or 23701x (relating to certain holding companies) may be exempt from franchise tax and income tax. The organization must apply for exemption, demonstrate it is organized and operated for nonprofit purposes, meet the requirements of one of the sections 23701a through 23701z, and receive a determination of its tax exempt status from the Franchise Tax Board. The exemption from income and franchise tax is not absolute and an organization may be subject to tax on unrelated business taxable income. (See Rev. & Tax. Code, §§ 23731, 23732, 23734, 23735.)

There is no requirement in section 23701 or California Code of Regulations, title 18, section 23701, that the corporation requesting exemption from taxation be organized under California law.

California did not adopt Internal Revenue Code section 501, Exemption From Tax on Corporations, Certain Trust, Etc., but adopted similar but separate requirements for tax-exempt corporations in section 23701, and sections 23701a through 23701z. Section 23701h conforms by reference to Internal Revenue Code section 501(c)((2). California Code of Regulations, title 18, section 23701(b)(1)(B)2 requires a taxpayer to inform the Franchise Tax Board if a federal determination is different from that of the Franchise Tax Board. Additionally, California Code of Regulations, title 18, section 23701(b)(2) allows the Franchise Tax Board to require evidence that an organization has established exempt status with the Internal Revenue Service. There is no authority in the Revenue and Taxation Code for a taxpayer to claim exemption from taxation based solely on a determination received from the IRS.

Section 23771 requires every exempt organization to file a tax return reporting unrelated business taxable income. Section 23772 requires every exempt organization to file an annual information return.

An entity cannot be exempt from franchise or income tax in California unless it has received a determination letter from the Franchise Tax Board. (Rev. & Tax. Code, § 23701.) Exempt status as determined by the Internal Revenue Service is considered by the Franchise Tax Board, but is not controlling in the determination of exemption from California income and franchise tax.

HOLDING

***** is a California LLC. For purposes of doing business, ***** is a separate entity and receives California source income from ***** . ***** is not considered to be doing business in California. Because ***** is not “doing business” in California, it is not subject to the franchise tax and does not have to qualify to transact intrastate business in California with the Secretary of State. As the result of the ownership of ***** , which has income producing property in California, ***** receives California source income and is subject to California income tax. Accordingly, ***** must submit an Exemption Application and receive a determination of exemption from taxation in accordance with California Revenue and Taxation Code section 23701 to be exempt from the income tax imposed by section 23501.

Any determination letters granting foreign corporations exemption from franchise or income tax should specifically state the requirements for full reporting of unrelated business taxable income and the information return required by California law.

Tax Counsel

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