Sunny State Shade: Arizona's Objection to California's Tax Reach

by Carley A. Roberts, Robert P. Merten III, and Mike Le

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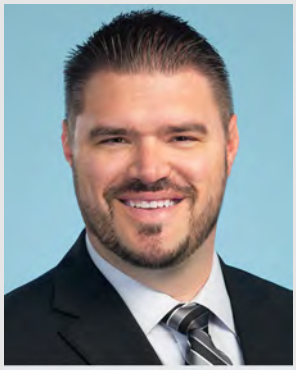

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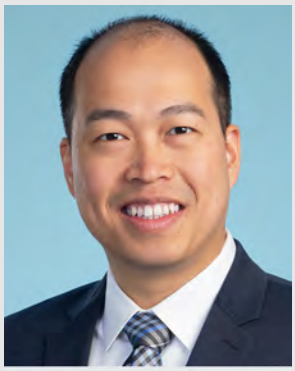

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In this installment of SeeSALT Digest, the authors evaluate and provide an update on Arizona's judicial objection to the reach of California's tax imposition on out-of-state companies whose only connection to California is a passive investment interest.

Introduction

California's jurisdiction to tax out-of-state companies has been a hot issue lately, especially regarding out-of-state companies whose sole involvement with California is limited to a passive investment such as holding a minority interest in an LLC. The issue has a long history, but many out-of-state companies have made justifiable business decisions not to litigate because the amount in dispute is frequently no more than the minimum tax of $800 per year.[1] And for the few who have successfully challenged the issue, there has been no inurement to other out-of-state companies due to the state's narrow interpretation or disregard for the resulting adverse judicial and administrative authorities.[2]

One can hardly fault California for its rigid stance. These minimum annual tax payments add up, and the state is responsible for ensuring the correct tax is paid by taxpayers to fund services important to residents. Considering that most companies will choose to pay $800 each year without strong dispute, and that the California Franchise Tax Board[3] purportedly assesses more than 100,000 companies per year,[4] California potentially collects at least $80 million annually from these tax payments, plus penalties and interest.

Against this backdrop, neighboring Arizona has brought the issue to light on a national scale by seeking U.S. Supreme Court guidance on behalf of its Arizona-based companies, which the state alleges are harmed by California's nexus

[1] A corporation "doing business" in California pays an annual minimum franchise tax of $800. Cal. Rev. & Tax Code (CRTC) sections 23151(a); 23153(d)(1). Similarly, a limited liability company or a limited partnership doing business in California pays an annual tax of $800. CRTC sections 17941; 17935.

[2] *See, infra*, discussions re: *Swart Enterprises Inc. v. Franchise Tax Board*, 7 Cal. App. 5th 497 (2017), and FTB Notice 2017-01 (Feb. 28, 2017); *see, infra*, discussion re: *In the Matter of the Appeal of Satview Broadband Ltd.*, OTA Case No. 18010756 (Sept. 25, 2018) and FTB Legal Ruling 2018-01 (Oct. 19, 2018); *see also, infra*, discussion re: *In the Matter of the Appeal of Jali LLC*, OTA Case No. 18073414 (July 8, 2019).

[3] The FTB is responsible for administering the personal income and corporation tax. CRTC section 19501.

[4] *See* Bill of Complaint, *Arizona v. California*, No. 22O150, 5 (U.S. Mar. 4, 2019).

standards.[5] Arizona's complaint takes issue with California's "aggressive policy of extraterritorial tax assessment and enforcement, which tramples over state borders and flouts well-established constitutional precedents," and argues that the Court "is the sole forum that can effectively put an end to California's pervasive constitutional violations."[6]

This article evaluates and provides an update on Arizona's judicial objection to the reach of California's tax imposition on out-of-state companies whose only connection to the Golden State is a passive investment interest.

Arizona's Suit in the U.S. Supreme Court

On February 28 Arizona filed an action against California in the Supreme Court under the Court's original and exclusive jurisdiction over controversies between two or more states.[7] Arizona alleges that California's overzealous imposition and collection of its annual and minimum taxes harms Arizona by decreasing the state's annual revenue every time an Arizona-based company pays the annual or minimum tax to California and then deducts that amount from its Arizona taxable income. The crux of Arizona's claim is California's "doing business" standard:

> California is not content to assess the "doing business" tax solely against entities actually conducting business in California, however. Instead, California assesses the "doing business" tax so expansively that it reaches out-of-state companies that do not conduct any actual business in California,[8] and indeed have no connection to the state except for purely passive investment in California companies (hereinafter "extraterritorial assessments").[9]

Arizona claims these extraterritorial assessments violate three constitutional provisions:

- the due process clause of the 14th Amendment;
- the commerce clause; and
- the Fourth Amendment.

First, Arizona alleges that because the due process clause requires a "minimum connection" between "a state and the person, property or transaction it seeks to tax," a standard that closely tracks the minimum contacts standard for asserting personal jurisdiction,[10] a passive investment in an LLC — without more — is insufficient to satisfy this standard.[11]

Second, in *Complete Auto Transit v. Brady*, the Supreme Court articulated a four-part test to determine if a state tax violates the commerce clause.[12] The Court held that it will sustain "a tax against Commerce Clause challenge when [1] the tax is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State."[13] Arizona alleges that California's extraterritorial assessments "impressively manage" to violate all four prongs of the *Complete Auto* test.[14]

Third, Arizona alleges that California's seizure orders to out-of-state banks, which require the banks to either transfer funds to California from its accounts of out-of-state taxpayers who are delinquent on their California taxes or else be directly subject to extraction of the same amounts instead, are unconstitutional on two grounds.[15] Arizona contends that these collection methods

[5] Motion for Leave to File Bill of Complaint, Bill of Complaint, and Brief in Support, *Arizona v. California*, No. 22O150 (U.S. Mar. 4, 2019) (Arizona Complaint).

[6] Arizona Complaint, at 2, 6.

[7] U.S. Const. Art. III, sec. 2, cl. 2; 28 U.S.C. section 1251(a).

[8] The CRTC does not require that an out-of-state corporation be engaged in a regular course of trade or business in California in order to be determined to be doing business in the state. *See also Golden State Theatre & Realty Corp. v. Johnson*, 21 Cal. 2d 493 (1943). Under California Corporations Code section 191(a), a company is determined to "transact intrastate business" in California if it enters into repeated and successive transactions of its business in the state. As a result of these different standards, an out-of-state corporation can be required to file a tax return for doing business in California even if it is not transacting intrastate business under the California Corporations Code.

[9] Arizona Complaint, at 2.

[10] In support of this principle, Arizona cites the Supreme Court's opinion in *South Dakota v. Wayfair Inc.*, 585 U.S. ___, 138 S. Ct. 2080, 2093 (2018).

[11] Arizona Complaint, at 32.

[12] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977).

[13] *Id.*

[14] Arizona Complaint, at 3.

[15] *Id.*

violate the due process clause because California lacks jurisdiction over both the out-of-state businesses and the out-of-state funds.[16] And according to Arizona, the seizure orders violate the Fourth Amendment for being issued without either a warrant or any other judicial involvement and for involving California's exercise of its sovereign power outside its territory.[17]

As a result of its LLCs paying extraterritorial assessments, Arizona claims the state itself is suffering harm.[18] Based on extrapolation, Arizona estimates that it loses approximately $484,000 in annual revenue because payment of taxes to California is generally a deductible business expense under Arizona law.[19]

Embedded in Arizona's allegations is frustration from its perception that California's extraterritorial assessments have been ongoing for decades with no end in sight:

> Indeed, while it is likely that California engages in well over 100,000 Extraterritorial Assessments a year (with an estimated 13,000-plus in Arizona alone), and has done so for at least a decade, those Extraterritorial Assessments have only led to a single precedential decision in the California state courts.[20] And that decision ducked the constitutional arguments presented here and has been adroitly evaded by California, which has limited the adverse precedent to its precise facts (both material and immaterial).[21]

To better understand Arizona's concern, a review of past authorities on this issue is informative. The issue whether passive investment in a California company is alone sufficient to subject an out-of-state company to California tax was first addressed in 1996 by the California State Board of Equalization.[22] Since then, there has been a cycle of what first appears to be some potential clarity on the issue in administrative- or judicial-level decisions, followed soon after by FTB guidance that either narrowly interprets precedential authority such as a court of appeal opinion, or disregards non-precedential authority like an Office of Tax Appeals (OTA) opinion that is not issued with precedential status.[23]

Before 1996 the FTB position was that all partners in a limited partnership were considered to be doing business in California by virtue of the limited partnership conducting business there. In 1996 the BOE disagreed and overruled the FTB's position in a case of first impression in *Appeal of Amman & Schmid Finanz AG*.[24] In this opinion, the BOE held that corporate limited partners were not doing business in California simply because they had interests as limited partners in limited partnerships that engaged in business in California.[25] The BOE compared the rights of a general partner with a limited partner and found that the corporate limited partners:

- were not bound by the partnership's obligations;
- had not participated in the control of the limited partnership's business;
- had no interest in specific partnership property; and
- only had an intangible property interest in the partnership.[26]

Four years after the BOE decided *Amman & Schmid*, the FTB issued Technical Advice Memorandum No. 200658 (Dec. 22, 2000), citing *Amman & Schmid* and holding that while an out-of-state LLC member receiving California-sourced

[16] *Id.*

[17] Arizona Complaint, at 4.

[18] Arizona Complaint, at 17.

[19] *Id.*

[20] *See, infra*, discussion re: *Swart*. Although California's doing business standard has been interpreted by both administrative and judicial bodies in the last 75 years, most are inapplicable to the issue underlying Arizona's suit. *See e.g., Golden State, supra* note 8 (holding that acquiring property on an irregular basis constitutes doing business); *Carson Estate Co. v. McColgan*, 21 Cal. 2d 516 (1943) (holding that purchasing bonds in one year and selling them in a different year constitutes doing business); and *Hise v. McColgan*, 24 Cal. 2d 147 (1944) (holding that under a liquidation, making sales, renting, transferring assets, and collecting notes and other obligations constitute doing business).

[21] Arizona Complaint, at 5.

[22] Before June 26, 2017, the BOE administered various statutory taxes and fees and performed administrative appellate duties, including hearing income tax appeals involving the FTB. However, on June 26, 2017, the Taxpayer Transparency and Fairness Act of 2017 transferred the BOE's administrative appellate duties to the OTA.

[23] OTA opinions can be precedential but only if designated as such in accordance with California Government Code section 11425.60. *See* Office of Tax Appeals Rules for Tax Appeals section 30502.

[24] 96-SBE-008 (1996).

[25] *Id.*

[26] *Id.*

income was subject to state income tax, it was not doing business for California franchise tax purposes.

However, the FTB later reversed course when it issued Legal Ruling 2014-01 (July 22, 2014), which describes *Amman & Schmid* as a "narrow exception" not applicable to LLCs.[27] The FTB ruled that if an LLC classified as a partnership is doing business in California, the LLC members are themselves doing business in California.[28] The FTB discussed a hypothetical example in the ruling titled "Situation 5," which involved a manager-managed LLC doing business in California.[29] In Situation 5, a corporation held a 15 percent interest in a manager-managed LLC; was not incorporated, organized, or registered to do business in California; and neither conducted activities nor had factor presence in California other than its (intangible) membership in the manager-managed LLC.[30] The legal ruling asserted that the member corporation must file a franchise tax return and pay corresponding taxes and fees resulting solely from its membership in the manager-managed LLC.[31]

This position was challenged by a taxpayer three years later in *Swart Enterprises Inc. v. Franchise Tax Board*.[32] In *Swart*, an out-of-state corporation's only connection to California was a 0.2 percent interest in a California manager-managed LLC.[33] The FTB contended that Swart was "doing business" in California and was thus required to file a return and pay an $800 minimum franchise tax.[34] The Court of Appeal disagreed, finding that Swart's passive holding of a 0.2 percent membership interest, with no right of control over the business affairs of the LLC, was insufficient to meet California's doing business standard.[35] The court described Swart as the "quintessential passive investor" and likened its interest in the LLC to that of a limited partner.[36] Citing *Amman & Schmid*, the court reasoned that because a partnership's business activities cannot be attributed to limited partners, Swart cannot be deemed to be doing business in California solely by virtue of its ownership interest in the LLC.[37]

Shortly after *Swart* was issued, the FTB issued Notice 2017-01 (Feb. 28, 2017), informing taxpayers and their representatives that the FTB "will follow the Court of Appeal decision in *Swart*, in situations with the same facts." The FTB also created a Claim for Refund Denial form tracking the narrow "same facts" from *Swart*, indicating that the refund claim would be denied if one or more of the following facts were not met:

- The only connection with California was 0.2 percent membership interest in an LLC doing business in California.
- The California LLC was manager-managed.
- The original members of the California LLC decided to delegate their authority to a manager before Swart Enterprises Inc. acquired its membership interest in the California LLC.[38]

In short, the FTB adopted a very narrow interpretation of *Swart*, requiring taxpayers to meet all three factual prerequisites, including the 0.2 percent membership interest, before granting a refund. This application of *Swart* has already resulted in numerous challenges at the newly established OTA, and a non-precedential decision issued in the *Appeal of Satview Broadband Ltd*.[39]

Satview involved a foreign corporation domiciled in Nevada that held a 25 percent passive, non-managing member interest in an LLC doing business in California.[40] The OTA determined that even though Satview's interest in the California LLC was significantly greater than the interest in *Swart* (25 percent as opposed to 0.2 percent), both percentages nonetheless involved minority interests.[41] Contrary to the FTB's previous position

[27] Legal Ruling 2014-01 (July 22, 2014), at 5.

[28] *Id*. at 4.

[29] *Id*. at 9.

[30] *Id*. at 10.

[31] *Id*.

[32] 7 Cal. App. 5th 497 (2017).

[33] *Swart*, 7 Cal. App. 5th, at 501.

[34] *Id*.

[35] *Id*. at 502-503.

[36] *Id*. at 510-511.

[37] *Id*. at 503.

[38] Arizona's Motion for Leave to File Bill of Complaint, *supra* note 5, Exhibit D.

[39] OTA Case No. 18010756 (Sept. 25, 2018) (non-precedential).

[40] *Satview*, at 2.

[41] *Id*. at 10.

on the issue, the OTA did not automatically attribute the doing business status of the passthrough entity to its non-managing minority members lacking in power or authority to participate in the LLC's management or operations.[42] Concluding that merely holding a non-managing minority interest was not enough to qualify as doing business in California, the OTA ruled for the taxpayer and against the FTB.[43]

Shortly after *Satview*, the FTB issued Legal Ruling 2018-01 (Oct. 19, 2018) to modify its prior Legal Ruling 2014-01. In doing so, the board disregarded the OTA's doing business analysis and conclusions in *Satview*. Legal Ruling 2018-01 characterizes *Swart* as a "narrow exception" applicable in limited circumstances, and does not include the language in the previous iteration of the ruling that "the distinction between a 'manager-managed' LLC and a 'member-managed' LLC is not relevant" to the doing business analysis.[44] Legal Ruling 2018-01 also notes in a hypothetical that a 15 percent membership interest, or 10 percent less than the fact pattern in *Satview*, "greatly exceeds" the 0.2 percent membership interest in *Swart*.[45]

Not less than a year after the FTB's *Satview* loss — and *after* Arizona filed its complaint — the FTB's position was rejected for a second time by the OTA and this time in a precedential decision. In *Appeal of Jali LLC*,[46] the FTB deemed Jali as actively doing business in California because its membership interest in an in-state LLC ranged between 1.12 to 4.75 percent, which "was well beyond the 0.2% *Swart* limit."[47] However, the OTA determined the FTB misconstrued *Swart* and found *Swart* was "squarely grounded on the relationship between the out-of-state member and the in-state LLC" and not simply based on ownership percentage.[48] The OTA then evaluated Jali's facts and found no evidence it had "any ability or authority, directly or indirectly, to influence or participate in the management or operation" of the LLC that conducted business in California.[49] Accordingly, the OTA found Jali was not doing business in California and therefore not subject to California tax.

Unknown at this time is how the FTB will respond to *Jali*. It is conceivable the FTB may narrowly interpret *Jali*, similar to how Notice 2017-01 (Feb. 28, 2017) narrowly interpreted *Swart*. Or the FTB may outright ignore *Jali*, similar to how Legal Ruling 2018-01 (Oct. 19, 2018) ignored *Satview*, though this may prove difficult given *Jali's* pending precedential label.[50] The FTB cannot appeal this decision to the Superior Court.[51]

California's Response and Later Actions

On May 24 California argued in an opposition brief to Arizona's pleadings that Arizona's action could not be maintained under the Court's original jurisdiction.[52] California asserted that Arizona companies may pursue actions on their own accord at the California administrative levels and in the state courts, and noted that many taxpayers are already doing so:

> [A] number of taxpayers are currently pursuing claims in California comparable to the ones Arizona seeks to assert on behalf of Arizona companies, and there is no indication that ordinary judicial processes are inadequate to resolve them.[53]

California also notes that two out-of-state entities have successfully challenged FTB assessments (in *Swart* and *Satview*), while other entities with different facts have had their claims denied.[54] Indeed, California can also now note that another taxpayer in *Jali* has also successfully challenged the FTB's assessment in a pending precedential opinion, lending further support for

[42] *Id*.

[43] *Id*.

[44] Legal Ruling 2018-01 (Oct. 19, 2018), at 1.

[45] *Id*. at 2.

[46] OTA Case No. 18073414 (July 8, 2019).

[47] *Jali*, at 4.

[48] *Id*.

[49] *Id*. at 5.

[50] Thirty days after a decision is posted as "Pending Precedential," the decision automatically becomes precedential unless noted as "Nonprecedential" on the OTA website. Cal. Code Regs., tit. 18, section 30502(e). Taxpayers can rely upon a precedential opinion. *See* Cal. Code Regs., tit. 18, section 30502(b); Gov. Code, section 11425.60(a).

[51] *See* Gov. Code, section 15677.

[52] California's Opposition Brief, *Arizona v. California*, No. 22O150 (U.S. May 24, 2019).

[53] *Id*. at 10.

[54] *Id*. at 18.

the FTB's claim that taxpayers themselves can find remedy in the California administrative and judicial system.

California argues that it would be inappropriate and impracticable to adjudicate thousands of individual taxpayers' refund claims in an original jurisdiction action in the U.S. Supreme Court.[55] California asserts that specific claims' merit depends on taxpayers' individual circumstances.[56] The state further contends that a due process inquiry must focus on the particular circumstances of each taxpayer, such as how active or passive the subject investment is and how substantial an interest the out-of-state entity has in the California LLC.[57] Moreover, California says that it would be inefficient for the Supreme Court to adjudicate claims for the more than 13,000 entities that Arizona estimates are at issue based on extrapolation in its moving papers.[58]

On June 3 Arizona filed a reply brief arguing that "California's opposition conjures phantom complexity to make the core issues of this case seem hopelessly complicated and fact-bound."[59] Arizona counters in its reply that the issue here is simple: Whether the mere fact of investment in a California company is alone sufficient to constitute minimum contacts with the state permitting out-of-state taxation.[60] Arizona highlights in its reply the FTB's position on this issue in Legal Ruling 2014-01, where the FTB "explains in black-and-white terms four times in four different examples that the 'doing business' tax may be imposed on businesses that 'ha[ve] no activities or factor presence in California other than through its membership in [an] LLC.'"[61]

Responding to California's point that Arizona companies may pursue actions on their own behalves at administrative levels and in state courts, Arizona again notes that "$800 is simply not enough to expect individual taxpayers to bring a full-blown constitutional case."[62] What is more, even fewer taxpayers are expected to litigate this issue given that California may lower the corporation minimum tax to as little as $200 depending on a corporation's gross receipts.[63] Arizona also reiterates that although California likely charged "extraterritorial assessments" over one million times since 2008, this has resulted in only one precedential decision (*Swart*), which California has "adroitly distinguished/narrowed into near nothingness."[64] Arizona can also point out that it took three taxpayers (*Swart*, *Satview*, and *Jali*) and two Legal Rulings (2014-01 and 2018-01) to finally obtain a precedential opinion.

Arizona's suit appears to have generated Supreme Court interest. On June 24 the Court invited the solicitor general to file a brief expressing the views of the United States. This means the solicitor general will offer his opinion on whether the Court should take on the case. Although the Court does not have to follow the solicitor general's recommendation, in recent years it has typically done so.[65]

Conclusion

Given that the Supreme Court invited the solicitor general to submit a brief on this issue, and the Court's recent interest in constitutional nexus cases,[66] it is certainly possible that the nation's highest court may hear this tax dispute between the sunny states. Otherwise, if the prevailing history in California is any indication, the persistent uncertainty regarding the issue will likely continue if the FTB continues to narrowly interpret or ignore precedential decisions like the *Jali* decision. ■

[55] *Id*.

[56] *Id*. at 22.

[57] *Id*. at 23.

[58] *Id*. at 25.

[59] Arizona's Reply Brief in Support of Motion for Leave to File a Bill of Complaint, *Arizona v. California*, No. 22O150, 1 (U.S. June 3, 2019).

[60] *Id*.

[61] *Id*.

[62] *Id*. at 11.

[63] *See* Sen. Bill No. 349 (2019-2020 Reg. Sess.), which would change the corporation minimum tax from $800 to a range of $200 through $800 depending on a corporation's gross receipts. Sen. Bill No. 349 passed the California Legislature and is currently sitting at the Governor's desk as of Sept. 11, 2019.

[64] *Id*.

[65] Kimberly Strawbridge Robinson, "Trump Solicitor General Has High Court's Ear as Ideologies Meet," Bloomberg Law (June 12, 2019).

[66] *See, e.g.*, *Wayfair*, *supra* note 10; and *North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019).