

California Office of Tax Appeals Rejects Franchise Tax Board's Broad Interpretation of California's "Doing Business" Standard

OTA rules in favor of out-of-state corporation.

By Pillsbury's SALT Team

TAKEAWAYS:

- The FTB has broadly interpreted California's "doing business" standard for decades.
- OTA *Satview* ruling demonstrates the new appellate body's willingness to dig into the law and not blindly follow known litigation positions by California's tax agencies.

The California Office of Tax Appeals (OTA) recently released to the public an opinion dated September 25, 2018 that rejected the California Franchise Tax Board's (FTB) extremely narrow interpretation and application of *Swart Enterprises, Inc. v. Franchise Tax Board*, 7 Cal.App.5th 497 (2017) involving California's "doing business" standard. The OTA concluded that a foreign corporation which held a 25 percent passive, non-managing member interest in an LLC which did business in California, was not itself doing business in California simply because it held that 25 percent interest. *In the Matter of the Appeal of Satview Broadband, Ltd.*, OTA Case No. 18010756 (9/25/18).

The FTB has broadly interpreted California's doing business standard for decades. (Since 2011, California has maintained two alternative statutory standards for "doing business" in California. Under California Revenue and Taxation Code Section 23101(a), a company is doing business in California if it is "actively engaging in any transaction for financial or pecuniary gain or profit" in California or the company meets specified economic nexus standards.)

In *Swart*, where the corporation's only connection to California was a 0.2 percent (yes, two-tenths of 1 percent) interest in a California member-managed limited liability company (LLC), the FTB contended *Swart Enterprises* was doing business in California and subject to tax. The California Court of Appeal disagreed, holding the passive membership interest was insufficient to meet California's statutory "doing business" standard. Shortly after *Swart* was issued, the FTB issued Notice 2017-01 (2/28/17), informing taxpayers and their representatives that the FTB "will follow the Court of Appeal decision in *Swart*, in situations with the *same facts*." (Emphasis added.) This means any interest over 0.2 percent in a California LLC would still be considered sufficient by the FTB to meet the state's "doing business" standard. *Satview Broadband* challenged the FTB's narrow interpretation of *Swart*.

Not surprisingly and consistent with its Notice, the FTB's only argument in *Satview* was that *Satview's* 25 percent non-managing member interest in a California LLC was far higher than *Swart's* 0.2 percent interest. The OTA rejected the FTB's argument. Relying on *Swart*, the OTA found the "doing business" status of a pass-through entity is not automatically attributed to its non-managing minority members where the non-managing minority member had no power or authority to participate in the LLC's management or operations. Although *Satview's* 25 percent non-managing member interest is significantly greater than *Swart's* 0.2 percent interest, both *Satview* and *Swart* held a minority interest in the in-state pass-through entity. The OTA concluded that merely holding a non-managing minority interest was not enough and, therefore, *Satview* was not doing business in California.

Team Insight: Creation and Purpose of the OTA

The OTA was created as a result of the Taxpayer Transparency and Fairness Act of 2017. The Legislature's adoption of the Act fell on the heels of several internal investigations into the operations of California's State Board of Equalization (BOE). (The initial investigations started in late 2015 and were conducted by the State Controller's Office and the Department of Finance. After those investigations, in April 2017, Gov. Jerry Brown ordered two additional investigations to be conducted by the Department of Human Resources and Department of Justice.) The Act stripped the BOE of its appellate powers and created the OTA as an independent appellate forum. The Legislature's primary purpose behind the creation of the OTA was to create an appeals process that is "fair, transparent, consistent, equitable, and impartial". (A.B. 102, ch. 16, § 2 (stats. 2017).) The OTA's legislative mandate includes issuance of decisions in a transparent fashion, relying on well-established precedents in tax law, and building a record that both taxpayers and tax administration agencies can rely upon. The OTA began operations on January 1, 2018. (Id.)

Taxpayers and their representatives have been watching the OTA with bated breath since it began operations earlier this year. Most are eager to see how the OTA flexes its muscles, particularly in corporate income tax appeals. Although the OTA has issued 150 decisions since the start of the year, less than one percent involved business entities.

Coincidentally, on October 19, 2018, the FTB issued Legal Ruling 2018-01, disregarding the OTA's "doing business" analysis and conclusions in *Satview*. Legal Ruling 2018-01 explains *Swart* is a "narrow exception" applicable in limited circumstances. In modifying an example in a prior Legal Ruling 2014-01 (7/22/14), Legal Ruling 2018-01 notes that a 15 percent membership interest "greatly exceeds" the 0.2 percent membership interest found in *Swart*.

Team Insight: Weight Afforded to FTB Legal Rulings

A Legal Ruling is a published interpretation by the FTB Chief Counsel and represents how the FTB believes the law should be applied. (FTB Notice 2009-08 (10/12/09) at p. 1.). A Legal Ruling is equivalent to an IRS Revenue Ruling. (Id.) The FTB considers its Legal Ruling to be its litigation position. Therefore, regardless of *Satview*, the FTB intends to continue to apply *Swart* narrowly. In addition, *Satview* is currently listed as a nonprecedential decision. Under the OTA's Emergency Regulations, "[a] published written opinion of OTA may be cited but is not precedential in any other appeal before OTA unless OTA designates the published written opinion as precedential..." 18 Cal. Code Regs. § 30502(b). However, under 18 Cal. Code Regs. § 30502(a), any person may propose that an opinion be given precedential effect.

The OTA's holding in *Satview* demonstrates the appellate body's willingness to dig into the law and not blindly follow known litigation positions taken by California's tax agencies. *Satview* provides hope the OTA will achieve its primary purpose of creating a "fair, transparent, consistent, equitable, and impartial" appeals process for all taxpayers.