State & Local Tax Subcommittee Meeting

Wednesday, March 22nd
4:30pm – 6:00pm
La Quinta Club & Resort, La Quinta, California

Co-Chairs:
Joseph Gurney, Director, Deloitte LLP
Tracy Swearingen, SVP-Taxation, Duke Realty Corporation

Panelists:
Drew Adams, VP & Director-Tax, Public Storage
Sam Melehani, Tax Partner, PwC
Michele Randall, Tax Partner-Real Estate SALT Leader, EY
Scott Smith, National Technical Practice Leader-State & Local Tax, BDO USA LLP

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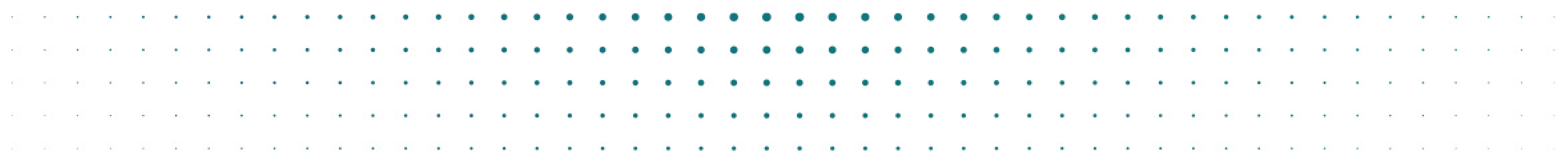
Wise® 2017

NAREIT's Law, Accounting & Finance Conference

March 22 – 24, 2017

SALT Subcommittee Meeting



Panelists

- **NAREIT SALT Subcommittee Co-Chairs:**
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Federal Tax Reform and Its Impact on State and Local Taxation

Impact of Federal Tax Reform on State and Local Taxes

- Background on Federal Tax Reform
  - President Trump's Reform Plan
    - Corporate and Pass-through Rate – 15%
    - Eliminate AMT
    - Repatriation Incentives
    - Changes to deductions involving business expenses and interest paid

Impact of Federal Tax Reform on State and Local Taxes

- Background on Federal Tax Reform
  - House of Representatives
    - Corporate Rate – 20%
    - Allows for businesses to expense 100% of costs (as apposed to depreciate)
    - Eliminates net interest expense for businesses

State Tax Issues Associated with Federal Tax Reform

- Conformity to the Internal Revenue Code
  - The vast majority of states fundamentally conform to the Internal Revenue Code ("IRC") either on a rolling basis or as the IRC existed at a certain date
  - Dramatic change to the IRC can fundamentally separate state tax codes from the IRC

State Tax Issues Associated with Federal Tax Reform

- Lowering the federal rate increases the relativity of the state tax rates
  - Under the House and President Trump’s proposed plans, the corporate rate would be somewhere between 15-20%
  - The highest rate for states varies from 3% to 12%

2017 State and Local Tax Updates

Recent State and Local Tax Updates

- The Alabama Tax Tribunal held that a financial institution taxpayer (a bank filing as a C Corp) was entitled to deductions for dividends received from a REIT, because the REIT is also considered a corporation under Alabama law.
  - *Ameris Bank v. Dep't of Revenue*; No. BIT. 16-255
- In Connecticut, REITs must file as part of a combined group (if the group is unitary).
  - *Regarding the Calculation of the Corporation Business Tax on a Combined Unitary Basis, OCG-3*

Recent State and Local Tax Updates

- NYC Tax Appeals Tribunal ruled that, for the purposes of the REIT transfer real estate transfer tax rate, the taxpayers' use of EMV to determine the transfer of controlling interest under the 40% test was supported by administrative code.
  - Matter of VCP One Park REIT LLC; TAT(H)14-26(RP)
- In a letter ruling, Tennessee Department of Revenue held that a REIT's distribution of a assets to a limited partner constituted a nontaxable return on capital and therefore was not subject to Tennessee Hall income tax.
  - TN Dept. of Rev. Ltr. Rul. # 16-11

Recent State and Local Tax Updates

- As in 2014, 2015, and 2016, legislation, H.B. 1012 and S.B. 1228, has been proposed in Hawaii to eliminate the dividends paid deduction (DPD) “temporarily” (for 15 years).
- Both would provide a limited exception for dividends attributable to affordable housing.
- The Hawaii house is expected to vote on H.B. 1012 on March 7th.
- S.B. 1228 was not heard in the Senate.

Partnership Audit Rules and REITs

Federal Partnership Audit Rules

- Bipartisan Budget Act of 2015
- It provides for one set of partnership-level audit rules that will apply to all partnerships, subject to an opt-out election available to some partnerships with 100 or fewer partners.
- Assess and collect tax at the partnership level, rather than for the partners
- NAREIT suggested regulatory comments (deficiency dividends)

State Implications

- Potential conflict – Nonresident Partner Withholding Obligations
  - A majority of states require partnerships to withhold taxes for some nonresident partners and directly remit those taxes to the state.
- Potential conflict – Composite Returns
  - A composite return is a return where a partnership files for its electing nonresident partners and computes and reports the income and tax attributable to the electing nonresident partners on a single return.
  - Deficiency dividends?

States' Reactions

- States have introduced legislation setting forth their own partnership audit rules in conjunction with IRC
  - Arizona SB 1288 – Passed in 2016 Legislative Session
  - Minnesota HF 1227 – Introduced to House
  - Montana HB 47 – Currently in legislative committee

General State Conformity Issues

Federal-Conformity Adjustments and Issues for REITs

- Non-Conformity
  - Captive REITs
- Adjustments
  - State and local income tax deduction
  - Depreciation
  - Intercompany/Related Party Add-backs (separate from the IRC § 1502 adjustments)

Allocation of Built-In Gains Among States

- Built-In Gains – Generally
  - When a C Corp converts to a REIT or when a C Corp transfers assets to a REIT in certain instances, the transaction is treated as if the assets were sold, resulting in taxable gain.
  - 5-Year recognition window
  - The gain is taxed at the highest corporate rate of 35%.
- New IRC § 337 Regulation
  - 10-year recognition window for REITs adjusted to 5-year

State Treatment of Built-In Gains

- General Conformity to built-in gains rules
  - Most states conform via IRC general conformity statutes
  - IRC generally only used to determine state starting point
- Recognized built-in gains subject to apportionment
  - *See* Iowa Code § 52.1(5), which states that S Corporations that are subject to the built-in gains tax under IRC § 1374 "are subject to Iowa corporation income tax on this income to the extent received from business carried on in this state or from sources in this state."
  - Potentially analogous to either DIT or installment sale income

State Real Estate Tax Issues for 2017

Forthcoming Developments

- California Supreme Court will hear *926 North Ardmore Avenue LLC v. County of Los Angeles* on April 5, 2017 to determine the applicability of California's documentary transfer tax is incurred by transferring a controlling interest in a legal entity holding real property interests

Forthcoming Developments

- New York State FY18 Budget Revenue Proposals
  - Part AA – change treatment of nonresident partner's sale of partnership interest in certain Rev. Rul. 99-6 transactions.
  - Part JJ – expands scope of real estate transfer tax to transfer of certain pass-through entities and non-publicly-traded corporations with an interest in New York real property.
- Philadelphia Bill 160810, effective 7/1/2017, will impose the realty transfer tax when 75% or more of a real estate company is transferred in any 6 year period.

AMERIS BANK f/k/a SOUTHLAND BANK §
24 2ND AVENUE SE
MOULTRIE, GA 31768, §

Taxpayer, §

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

STATE OF ALABAMA
ALABAMA TAX TRIBUNAL

DOCKET NO. BIT. 16-255

FINAL ORDER

The Revenue Department assessed Southland Bank for financial institution excise tax ("FIET") for 2002 through 2005 and the short year ending 2/28/06, and American Banking Company for the short year ending 12/31/06 and 2013. Ameris Bank ("Taxpayer"), the successor to Southland Bank and American Banking Company, appealed the final assessments to the Tax Tribunal pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. The case was submitted on a joint stipulation of facts and briefs. Attorneys David Willoughby, Dan Lane, Bruce Ely, and Jimmy Long represented the Taxpayer. Assistant Counsel Ralph Clements represented the Revenue Department.

The Taxpayer received dividends from Southland Real Estate Holdings, Inc. ("Southland"), a majority-owned subsidiary of the Taxpayer, during the years in issue. The Taxpayer deducted the dividends on its Alabama FIET returns for those years pursuant to Code of Ala. 1975, §40-16-1(2)g. That statute allows a financial institution a FIET deduction for "[t]he amount received as dividends from a corporation organized and existing under the laws of the State of Alabama. . . ."

The Department reviewed the returns and disallowed the dividends received deduction in each year. The Department's initial position, as set out in its Answer, at 2, was as follows:

> The Department's position before this Tribunal is that (I) the Bank is not entitled to the dividends received deduction because the REIT from which the dividends were received is not a "corporation" under Alabama law, and (II) that both the REIT and the Bank are necessary components of the Financial Institution commonly known as Ameris Bank (the "Taxpayer"), and because the Financial Institution Excise Tax is levied upon Financial Institutions and not individual persons or corporations, the payment of dividends from the REIT to the Bank are disregarded for tax purposes as intra-company transfers.

The Department subsequently dropped its second contention that Southland and the Taxpayer are a single financial institution, and that the dividends paid by Southland to the Taxpayer should be disregarded for tax purposes as intra-company transfers. Consequently, the sole remaining issue is whether Southland, as a REIT, can also be a corporation, and vice versa, under Alabama law.

The following relevant facts were stipulated by the parties:

> 2. For the tax years ended 12/31/1999 through 2/10/2006, the Taxpayer was an Alabama banking corporation known as Southland Bank and commercially domiciled in Dothan, Alabama. Effective as of February 10, 2006, Southland Bank merged with and into Ameris Bank (f/k/a American Banking Company), a Georgia banking corporation commercially domiciled in Moultrie, Georgia.
>
> 3. Southland Real Estate Holdings, Inc. ("Southland") was duly formed in the State of Alabama on July 8, 1999, by the filing of Articles of Incorporation with the Secretary of State of Alabama pursuant to the Alabama Business Corporation Act.
>
> 4. Although at all times at issue in the above-styled appeal, Southland was a majority-owned subsidiary of the Taxpayer, of which the Taxpayer owned all the outstanding common stock, at no such time was Southland wholly owned by the Taxpayer, as at all such times at least 100 individuals also owned preferred stock of Southland.
>
> 5. At all times at issue in the above-styled appeal, Southland was a "real estate investment trust" as that term is defined in Internal Revenue Code § 856(a) ("REIT").

6. At all times at issue in the above-styled appeal, Southland filed federal income tax returns as a qualified REIT under the Internal Revenue Code.

7. At all times at issue in the above-styled appeal, Southland filed Alabama corporate income tax returns as a qualified REIT in accordance with Ala. Code §10A-10-1.21.

8. The Taxpayer did not file a consolidated FIET return including Southland or any other affiliate for any of the tax years at issue in the above-styled appeal.

9. Without regard to the issue of whether dividends received by the Taxpayer from Southland are deductible for purposes of the FIET under Ala. Code § 40-16-1(2)g., there is no dispute as to the amount of the dividends received and claimed as deductions on the Taxpayer's annual FIET returns for the tax years at issue in the above-styled appeal.

14. The Department has not issued an administrative rule, public notice or other public announcement regarding the issue of whether a "financial institution" under the FIET statute must include the assets and income of a REIT subsidiary in its FIET return and FIET tax base in order to meet the statutory definition of a "financial institution."

The parties subsequently submitted the following additional stipulation of fact:

1. The Taxpayer's Alabama REIT subsidiary, Southland Real Estate Holdings, Inc., has never received deposits at any time at issue in the above-styled appeal.

As discussed, §40-16-1(2)g allows a financial institution subject to Alabama's FIET to deduct dividends received "from a corporation organized and existing under the laws of the State of Alabama." The parties have stipulated that the Taxpayer received dividends from Southland, and that Southland was a REIT in the subject years. The case thus turns on whether Southland, as a REIT, was also a "corporation organized and existing" under Alabama law in those years. If so, the deduction must be allowed.

The Department argues that because Southland is a REIT, it cannot also be a corporation under Alabama law. It further asserts that Southland's Articles of Incorporation

specify that "[t]he Corporation's activities shall be limited in such manner to qualify for and maintain status as a real estate investment trust. . . ." It thus contends that because Southland elected to be treated as a REIT in the subject years, it must be recognized as a REIT and not a corporation for tax purposes. "When an entity makes the election to be taxed as a REIT . . . it elects to be treated by the tax law as something different than an ordinary corporation . . ., although state law may still regard the entity as a corporation (or an LLC), the tax law deems the entity to be what it has elected to be, regardless of the actual form." Department's Reply Brief at 5, 6.

Finally, the Department claims that because Southland is allowed to deduct its dividends paid out in a tax year for income tax purposes pursuant to IRC 26 U.S.C. §857(b)(2)(B), if the Taxpayer is also allowed to deduct the dividends received from Southland for FIET purposes, the Southland income will escape taxation. "In effect, the same income has been deducted <u>twice</u>, and therefore no state-level tax will have been imposed <u>at all</u>. This cannot be what the law intends, and the presumption should be heavy that the legislature did not intend an absurd result." (emphasis in the original) Department's Reply Brief at 7.

The parties stipulated that Southland was formed in Alabama in 1999 pursuant to the Alabama Business Corporation Act, Code of Ala. 1975, §10-2B-1.01 et seq. Section 10-2B-1.40(4) of that Act defined "corporation" as "a corporation for profit, . . . incorporated under or subject to the provisions of this chapter." The Taxpayer also submitted a certified document dated May 16, 2016 from the Alabama Secretary of State's office showing that Southland was still existing under Alabama law as of the above date. Consequently, because Southland was organized as a corporation under Alabama law, i.e., the Alabama

Business Corporation Act, and existed under Alabama law during the years in issue, the Taxpayer is entitled to deduct the dividends received from Southland under the plain, unambiguous language of §40-16-1(2)g.

The Department's claim that because Southland is a REIT, it cannot also be a corporation, is a red herring. The deduction applies if the entity that pays the dividends, Southland in this case, is a corporation organized and existing under Alabama law. If that criteria is satisfied, the deduction must be allowed. As discussed, Southland was organized under Alabama law in 1999, and was existing under Alabama law during the years in issue. The deduction clearly applies by the plain language of the statute. End of analysis. The fact that Southland elected to operate and be taxed as a REIT for federal and Alabama income tax purposes is irrelevant. And contrary to the Department's claim, federal and Alabama law both clearly envision that a REIT can also be a corporation.

The Alabama Real Estate Investment Trust Act was enacted in 1995 pursuant to Acts 1995, No. 95-628. That Act, at §10-13-2(1), defined a "Real Estate Investment Trust" as "[a]n unincorporated trust or association . . . or an entity that otherwise complies with the provisions of 26 U.S.C. §§856 to 858, inclusive, of the U.S. Internal Revenue Code. . . ."[1] Section 856(a) plainly specifies that "[f]or purposes of this title, the term 'real estate investment trust' means a corporation, trust, or association. . . ." A REIT can thus also be a corporation, and vice versa, for both federal and Alabama purposes.

The Alabama Secretary of State requested an opinion from the Alabama Attorney General in 1997 as to whether a foreign REIT could conduct business in Alabama. In

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[1] A substantively identical definition of a REIT is now found at §10A-10-1.02(1).

Opinion 1997-116, the Attorney General concluded that a foreign REIT could conduct business in the State. Importantly, the Opinion also found that a REIT may also be a corporation under Alabama law.

> A REIT may be organized as a corporation, a trust, or an unincorporated association. IRC § 856(a). If the REIT is organized as a foreign corporation and transacts business in Alabama, the REIT must comply with the foreign corporation provision of the [ABCA]. If the REIT is organized as an Alabama corporation, the REIT must comply with the provisions of the ABCA applicable to Alabama corporations. The REIT Act principally refers to trust, but includes within the definition of a REIT any entity that complies with the provisions of IRC §§ 856 to 858. *Id.*, §10-13-2(1). Thus, a corporate REIT is also subject to the provisions of the REIT Act.

Ala. Att'y Gen. Op. 1997-116, at 2.

The Department concedes in its Pretrial Brief, at 4, that "[t]he definition of a REIT incorporated in Alabama's code (I.R.C. §856) provides that a real estate investment trust is 'a corporation, trust, or association' meeting several conditions." It then argues, however, that the corporation, trust, or association cannot be a financial institution, which includes "a bank," see §582(c)(2)(A)(i). "Bank" is defined at §581 as "a bank or trust company . . ., a substantial part of the business of which consists of receiving deposits and making loans."

The Department stipulated that Southland did not receive deposits during the years in issue. It nonetheless asserts that Southland is a bank, as defined above, because it made loans in the subject years. It argues that the phrase "receiving deposits and making loans" should not be conjunctive, and that conducting either activity is sufficient to qualify Southland as a bank. The Department asserts that, "despite the use of the word 'and' to join these two activities, that the word's use here is not conjunctive; that is, that receiving deposits and making loans are examples of activities that make an entity a bank, but not that each and every activity in the description is required." Department's Reply Brief at 3. I

disagree.

The language of the statute is clear. To qualify as a bank pursuant to §581, a substantial part of the entity's business must consist of both receiving deposits and making loans. The disjunctive conjunction "or" cannot be substituted for the conjunctive conjunction "and" used in the statute.[2] Southland thus clearly is not a bank that is prohibited from being a corporate REIT pursuant to §856(a)(4).

I recognize the Department's contention that because Southland, as a REIT, is allowed to deduct the dividends it paid to the Taxpayer for income tax purposes, if the Taxpayer is also allowed to deduct the dividends received for FIET purposes, no State tax will be paid on Southland's income. The Alabama Supreme Court has held, however, that if a taxpayer qualifies for a tax deduction under Alabama law, the deduction must be allowed. *Ex parte Sonat, Inc.*, 752 So.2d 1211 (Ala. 1999).

In *Sonat*, the company deducted for income tax purposes a $185 million dividend it had received from a subsidiary ("SODI") in 1988. At the time, Code of Ala. 1975, §40-18-35(a)(4) allowed a deduction for dividends received from certain affiliated corporations; provided, that the net income of the payor corporation was taxable in Alabama.

SODI's sole activity in Alabama was the leasing of a workstation to another company in Birmingham for $145 a month. The parties stipulated that SODI was qualified to do business and was doing business in Alabama in the subject year.

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[2] The Alabama Supreme Court has held that "courts are at liberty in ascertaining the intent (of a statute) to hold that the disjunctive conjunction 'or' and the conjunctive conjunction 'and,' sometimes carelessly used, are interchangeable, to discover the intent of the writing." *In re Opinion of the Justices*, 41 So.2d 559, 563 (Ala. 1949). There is no indication, however, that the conjunctive "and" used in §581 was "carelessly used" or otherwise unintended.

The Department disallowed the dividends received deduction and assessed Sonat accordingly. On appeal, the circuit court found that because Sonat qualified for the deduction under the plain language of the statute, it must be allowed.

The Department appealed to the Court of Civil Appeals, which reversed, holding that while the deduction "may fall within the letter of §40-18-35(a)(14), it falls well outside its spirit and intent. . . ." *Alabama Department of Revenue v. Sonat, Inc.*, 752 So.2d 1206, 1210 (Ala. Civ. App. 1997).

The Taxpayer appealed to the Alabama Supreme Court, which held that because Sonat technically qualified for the deduction, it must be allowed, regardless of the motivation or result. The Supreme Court quoted the circuit court's Order and Opinion, which reads in pertinent part as follows:

> The Department urges the Court to find that Sonat and SODI entered into the lease of the office workstation for the sole purpose of qualifying its dividends for the deduction under § 40-18-35(a)(14). The Department asks the Court to apply the federal tax doctrine of 'substance over form' and to disregard the lease so as to deny Taxpayer the dividends received deduction. The Court agrees with the Department that it seems likely that the primary, if not the sole, purpose of the SODI/SNG lease was to qualify Sonat for the dividends received deduction. Even if this were the sole purpose of the lease, that does not make it a 'sham' nor does it mean that the transaction should be disregarded. The Court finds that whatever the motivation, the lease was 'real,' the workstation was located in Alabama, and the rent was paid. Under the unambiguous language of the applicable statutes, the Court has concluded that this was a legal method available to the Taxpayer to diminish its Alabama income tax liability.
>
> SODI is a wholly owned subsidiary corporation of Sonat. SODI is taxable in Alabama upon its net income; that is, its gross income from sources within Alabama, less its legal deductions. SODI is qualified to do business in Alabama and does business in Alabama. It derives income from property located in Alabama. The dividends SODI pays its parent corporation, Sonat, are therefore deductible by Sonat under Ala. Code (1975) § 40-18-35(a)(14). This result is mandated by the unambiguous language of the statutes and the motivation of the Taxpayer in entering into the lease arrangement is not

> relevant. If this is not the intended result, then the legislature should amend the statute.
>
> The best statement this Court has found of Alabama law concerning the right of a taxpayer to take advantage of legal methods of tax avoidance was written in 1938 and is still valid law:
>
> > This taxpayer has simply and only set itself up in conformity to the law and proposes to pay the taxes which the law says are payable when so set up. The State cannot complain when the tax payer resorts to a legal method available to him to compute his tax liability. The State is now saying to him that although you did what we said you could do with a certain result, that result is more beneficial to you than we intended. This court cannot change the law as thus made by our Constitution and statutes.
> >
> > Every corporation was created as a legal method of avoiding a personal liability of its stockholders, or to have the benefit of some other law enacted for the purpose of stimulating such a business enterprise. It seems that it is more to the discredit of the State to seek to withdraw such benefits after they have been accepted and acted upon, than to those who thus act in reliance upon their effective operation.
>
> State v. Pullman[-Standard Car] Mfg. Co., 235 Ala. 493, 179 So. 541 (1938)

Sonat, 752 So.2d at 1215, 1216.

The Supreme Court then agreed with the circuit court's rationale, holding that the motive for SODI renting the workstation in Alabama was irrelevant.

> The Department further argues that SODI's workstation lease was made for the purpose of qualifying Sonat for the deduction under § 40-18-35(a)(14) and thereby avoiding the payment of Alabama income tax by both Sonat and SODI. However, the motivation for the workstation lease does not affect the deductibility of the SODI dividend under § 40-18-35(a)(14). "A taxpayer may resort to any *legal* method available to it in an effort to diminish the amount of its tax liability." *West Point Pepperell, Inc. v. State Dep't of Revenue*, 624 So. 2d 579, 582 (Ala. Civ. App. 1992), writ quashed as improvidently granted, 624 So. 2d 582 (Ala. 1993) (citing *State v. Pullman-Standard Car Mfg. Co.*, 235 Ala. 493, 179 So. 541 (1938)). Regardless of the purpose of the workstation lease, the fact remains that it was a bona fide lease--the workstation was situated in Alabama and rent was paid to SODI for its use.

Sonat, 752 So.2d at 1219.[3]

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[3] For a similar holding, see *HMN Fin., Inc. v. Comm'r of Revenue*, 782 N.W.2d 558, 2010 Minn. LEXIS 243 (May 20, 2010). In that case, a bank holding company, HMN Financial, owned all of the stock of a bank, HF Bank. HF Bank in turn incorporated Home Federal REIT, or HF REIT. The above captive REIT structure greatly reduced HMN Financial's Minnesota tax liability. The Commissioner of Revenue ignored the REIT structure because, according to the Commissioner, it lacked economic substance and a business purpose.

The Minnesota Supreme Court first found, and HMN did not dispute, that the REIT structure was motivated solely by tax avoidance. It nonetheless held that because HMN had complied with Minnesota's laws in creating the REIT structure, it must be recognized and allowed. The Court held in pertinent part, as follows:

> The Commissioner cites a number of our cases for the proposition that he has the broad authority to tax according to substance rather than form. But none of these cases embraces the radical position that the Commissioner may disregard statutes that allow certain business structures favorable tax treatment. Rather, those cases emphasize the proper role of our court to construe the relevant statutes to determine if a taxpayer is in compliance with those statutes. (footnote omitted) If Minnesota statutes allow a favorable tax treatment, neither our court nor the Commissioner has the power to disregard those statutes and impose a different tax treatment. And, if we conclude a taxpayer has complied with the relevant statutes, that ends our analysis. *See Stretar Masonry Co. v. Comm'r of Revenue,* 518 N.W.2d 29, 32-33 (Minn. 1994). Here, we conclude that HMN complied with the relevant tax statutes.
>
> It is evident that the Commissioner disfavors the tax treatment HMN received. He has attacked the validity of that tax treatment from every conceivable angle. But the fact remains that HMN complied with the tax statutes in structuring its business, and those statutes, as they existed during the relevant tax years, allowed the favorable tax treatment HMN received.
> We hold that neither Minnesota statutes nor case law grants the Commissioner the power to disregard HMN's business structure in assessing HMN's taxes. When a business with all of the relevant tax statutes, that business is subject to tax in accordance with those statutes. Here HMN's captive REIT structure complied with relevant statutes during the tax years at issue, and HMN is subject to the taxation only as laid out in those statutes. Therefore, we hold that the tax court erred when it concluded that the Commissioner possessed both statutory and common law authority to disregard HMN's captive REIT structure despite the fact that HMN complied with relevant tax statutes in structuring its business and reporting its income.

HMN Fin., 782 N.W. 2d at 570-571.

Southland was no doubt incorporated as a REIT in 1999 because of the favorable tax advantages afforded REITs by federal and Alabama law. The incorporators were well within their legal rights to do so. A taxpayer is entitled to arrange or organize its business affairs so as to take advantage of all legal means of reducing its tax liability. *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266 (1935)

The Department argues that the FIET dividends received deduction at §40-16-1(2)g. was enacted in 1935, and that the drafters could not have envisioned the advent of REITs that are allowed to deduct their paid out dividends. "The structure set up by the FIET is not designed to operate with corporations that may deduct their dividends." Department's Reply Brief at 6. But the fact that the legislators that passed the FIET statutes in 1935 could not have envisioned the advent of REITs is irrelevant.

The Alabama Legislature is presumed to know the law, and the effect a newly enacted statute may have on existing law. "It is a familiar principle of statutory construction that the Legislature, in enacting new legislation, is presumed to know the existing law." *Ex parte Fontaine Trailer Co. and Ex parte International Truck & Engine Corp. v. Parker*, 854 So.2d 71, 83 (Ala. 2003), quoting *Blue Cross & Blue Shield of Alabama, Inc. v. Nielsen*, 714 So.2d 293, 297 (Ala. 1998). It consequently must be presumed that when the Legislature enacted the Alabama Real Estate Investment Trust Act, Acts 1995, No. 95-628, in 1995, it knew that for FIET purposes, a financial institution could deduct dividends received from corporations organized and existing under Alabama law. It must further be presumed that the Legislature was aware that the 1995 Act defined a REIT, at §10-13-2(1), to include entities that complied with I.R.C. §856, i.e., corporations. Consequently, it must

be presumed that the Legislature was aware that dividends paid to a financial institution by a corporate REIT incorporated and existing under Alabama law could be deducted by the REIT for income tax purposes, and also by the financial institution for FIET purposes pursuant to §40-16-1(2)g.

Knowing the above consequences of enacting the REIT Act in 1995, the Legislature could have amended the §40-16-1(2)g. deduction so as to exclude from the deduction dividends paid by corporate REITs organized and existing under Alabama law. The Legislature elected not to, and the Department is now asking the Tribunal to so amend the statute by judicial fiat. It is the role of the Alabama Legislature to amend a statute, not the courts. As held by the Alabama Supreme Court in *Parker v. Hilliard*, 567 So.2d 1343 (Ala. 1990):

> In the area of statutory construction, the duty of a court is to ascertain the legislative intent from the language used in the enactment. When the statutory pronouncement is clear and not susceptible to a different interpretation, it is the paramount judicial duty of a court to abide by the clear pronouncement. See *Ex parte Rodgers*, 554 So.2d 1120 (Ala. 1989), and *East Montgomery Water, Sewer & Fire Protection Authority v. Water Works and Sanitary Sewer Bd. Of the City of Montgomery*, 474 So.2d 1088 (Ala. 1985). Courts are supposed to interpret statutes, not to amend or repeal them under the guise of judicial interpretation.

Parker, 567 So.2d at 1346.

The final assessments in issue are voided. Judgment is entered accordingly.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2B-2(m).

Entered February 9, 2017.

BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
cc: Ralph M. Clements, III, Esq.
David D. Willoughby, Esq.
Dan F. Laney, Esq.
Bruce P. Ely, Esq.
James E. Long, Jr., Esq.

HOUSE OF REPRESENTATIVES
TWENTY-NINTH LEGISLATURE, 2017
STATE OF HAWAII

H.B. NO. 1012 H.D. 1

A BILL FOR AN ACT

RELATING TO REAL ESTATE INVESTMENT TRUSTS.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF HAWAII:

1 SECTION 1. The legislature finds that, under current law,
2 real estate investment trusts are entitled to a deduction for
3 dividends paid. This deduction results in the loss of
4 potentially millions of dollars of tax revenue to the State each
5 year. The department of business, economic development, and
6 tourism estimates that, in 2014, this deduction resulted in
7 $36,000,000 in corporate income tax revenue being forgone. If
8 dividends paid by real estate investment trusts were not
9 deductible, the dividends would be effectively taxed prior to
10 distribution. This is significant because trust shareholders
11 who reside in other states receive dividends from the trust, but
12 pay taxes on those dividends to those other states. It should
13 be noted that very few Hawaii taxpayers (between 0.5 per cent
14 and three per cent) invest in real estate investment trusts with
15 property in Hawaii. As a result, a number of states other than
16 Hawaii receive tax revenue, leaving Hawaii taxpayers to
17 essentially subsidize the costs of the infrastructure and

1 government services that support properties owned by these
2 trusts. Therefore, the legislature further finds that repealing
3 the current deduction would promote fairness in the treatment of
4 similar, but differently organized, business entities and would
5 generate additional revenue for state programs.
6 The legislature further finds that, given the State's
7 affordable housing crisis, action must be taken sooner, rather
8 than later, to provide more revenue to the State and relieve the
9 pressures of this crisis.
10 The purpose of this Act is to temporarily disallow the
11 deductions for dividends paid by real estate investment trusts
12 for a period of fifteen years, but with an exception for
13 dividends generated from trust-owned housing that is affordable
14 to households with incomes at or below one hundred forty per
15 cent of the median family income, as determined by the United
16 States Department of Housing and Urban Development.
17 SECTION 2. Section 235-2.3, Hawaii Revised Statutes, is
18 amended by amending subsection (b) to read as follows:
19 "(b) The following Internal Revenue Code subchapters,
20 parts of subchapters, sections, subsections, and parts of

1 subsections shall not be operative for the purposes of this
2 chapter, unless otherwise provided:
3 (1) Subchapter A (sections 1 to 59A) (with respect to
4 determination of tax liability), except section
5 1(h)(2) (relating to net capital gain reduced by the
6 amount taken into account as investment income),
7 except sections 2(a), 2(b), and 2(c) (with respect to
8 the definition of "surviving spouse" and "head of
9 household"), except section 41 (with respect to the
10 credit for increasing research activities), except
11 section 42 (with respect to low-income housing
12 credit), except sections 47 and 48, as amended, as of
13 December 31, 1984 (with respect to certain depreciable
14 tangible personal property), and except section
15 48(d)(3), as amended, as of February 17, 2009 (with
16 respect to the treatment of United States Department
17 of Treasury grants made under section 1603 of the
18 American Recovery and Reinvestment Tax Act of 2009).
19 For treatment, see sections 235-110.91, 235-110.7, and
20 235-110.8;

1 (2) Section 78 (with respect to dividends received from
2 certain foreign corporations by domestic corporations
3 choosing foreign tax credit);
4 (3) Section 86 (with respect to social security and tier 1
5 railroad retirement benefits);
6 (4) Section 103 (with respect to interest on state and
7 local bonds). For treatment, see section 235-7(b);
8 (5) Section 114 (with respect to extraterritorial income).
9 For treatment, any transaction as specified in the
10 transitional rule for 2005 and 2006 as specified in
11 the American Jobs Creation Act of 2004 section 101(d)
12 and any transaction that has occurred pursuant to a
13 binding contract as specified in the American Jobs
14 Creation Act of 2004 section 101(f) are inoperative;
15 (6) Section 120 (with respect to amounts received under
16 qualified group legal services plans). For treatment,
17 see section 235-7(a)(9) to (11);
18 (7) Section 122 (with respect to certain reduced uniformed
19 services retirement pay). For treatment, see section
20 235-7(a)(3);

1 (8) Section 135 (with respect to income from United States
2 savings bonds used to pay higher education tuition and
3 fees). For treatment, see section 235-7(a)(1);
4 (9) Section 139C (with respect to COBRA premium
5 assistance);
6 (10) Subchapter B (sections 141 to 150) (with respect to
7 tax exemption requirements for state and local bonds);
8 (11) Section 151 (with respect to allowance of deductions
9 for personal exemptions). For treatment, see section
10 235-54;
11 (12) Section 179B (with respect to expensing of capital
12 costs incurred in complying with Environmental
13 Protection Agency sulphur regulations);
14 (13) Section 181 (with respect to special rules for certain
15 film and television productions);
16 (14) Section 196 (with respect to deduction for certain
17 unused investment credits);
18 (15) Section 199 (with respect to the U.S. production
19 activities deduction);
20 (16) Section 222 (with respect to qualified tuition and
21 related expenses);

1 (17) Sections 241 to 247 (with respect to special
2 deductions for corporations). For treatment, see
3 section 235-7(c);
4 (18) Section 280C (with respect to certain expenses for
5 which credits are allowable). For treatment, see
6 section 235-110.91;
7 (19) Section 291 (with respect to special rules relating to
8 corporate preference items);
9 (20) Section 367 (with respect to foreign corporations);
10 (21) Section 501(c)(12), (15), (16) (with respect to exempt
11 organizations); except that section 501(c)(12) shall
12 be operative for companies that provide potable water
13 to residential communities that lack any access to
14 public utility water services;
15 (22) Section 515 (with respect to taxes of foreign
16 countries and possessions of the United States);
17 (23) Subchapter G (sections 531 to 565) (with respect to
18 corporations used to avoid income tax on
19 shareholders);
20 (24) Subchapter H (sections 581 to 597) (with respect to
21 banking institutions), except section 584 (with

1 respect to common trust funds). For treatment, see
2 chapter 241;
3 (25) Section 642(a) and (b) (with respect to special rules
4 for credits and deductions applicable to trusts). For
5 treatment, see sections 235-54(b) and 235-55;
6 (26) Section 646 (with respect to tax treatment of electing
7 Alaska Native settlement trusts);
8 (27) Section 668 (with respect to interest charge on
9 accumulation distributions from foreign trusts);
10 (28) Subchapter L (sections 801 to 848) (with respect to
11 insurance companies). For treatment, see sections
12 431:7-202 and 431:7-204;
13 (29) Section 853 (with respect to foreign tax credit
14 allowed to shareholders). For treatment, see section
15 235-55;
16 (30) Section 853A (with respect to credits from tax credit
17 bonds allowed to shareholders);
18 (31) Section 857(b)(2)(B) (with respect to the deduction
19 for dividends paid by real estate investment trusts);
20 provided that the deduction shall remain available for
21 dividends generated from trust-owned housing that is

1 affordable to households with incomes at or below one
2 hundred forty per cent of the median family income, as
3 determined by the United States Department of Housing
4 and Urban Development;
5 [~~(31)~~] (32) Subchapter N (sections 861 to 999) (with respect
6 to tax based on income from sources within or without
7 the United States), except sections 985 to 989 (with
8 respect to foreign currency transactions). For
9 treatment, see sections 235-4, 235-5, and 235-7(b),
10 and 235-55;
11 [~~(32)~~] (33) Section 1042(g) (with respect to sales of stock
12 in agricultural refiners and processors to eligible
13 farm cooperatives);
14 [~~(33)~~] (34) Section 1055 (with respect to redeemable ground
15 rents);
16 [~~(34)~~] (35) Section 1057 (with respect to election to treat
17 transfer to foreign trust, etc., as taxable exchange);
18 [~~(35)~~] (36) Sections 1291 to 1298 (with respect to treatment
19 of passive foreign investment companies);

[~~(36)~~] (37) Subchapter Q (sections 1311 to 1351) (with respect to readjustment of tax between years and special limitations);

[~~(37)~~] (38) Subchapter R (sections 1352 to 1359) (with respect to election to determine corporate tax on certain international shipping activities using per ton rate);

[~~(38)~~] (39) Subchapter U (sections 1391 to 1397F) (with respect to designation and treatment of empowerment zones, enterprise communities, and rural development investment areas). For treatment, see chapter 209E;

[~~(39)~~] (40) Subchapter W (sections 1400 to 1400C) (with respect to District of Columbia enterprise zone);

[~~(40)~~] (41) Section 1400O (with respect to education tax benefits);

[~~(41)~~] (42) Section 1400P (with respect to housing tax benefits);

[~~(42)~~] (43) Section 1400R (with respect to employment relief);

1 [~~(43)~~] (44) Section 1400T (with respect to special rules for
2 mortgage revenue bonds);
3 [~~(44)~~] (45) Section 1400U-1 (with respect to allocation of
4 recovery zone bonds);
5 [~~(45)~~] (46) Section 1400U-2 (with respect to recovery zone
6 economic development bonds); and
7 [~~(46)~~] (47) Section 1400U-3 (with respect to recovery zone
8 facility bonds)."
9 SECTION 3. Section 235-71, Hawaii Revised Statutes, is
10 amended by amending subsection (d) to read as follows:
11 "(d) In the case of a real estate investment trust there
12 is imposed on the taxable income, computed as provided in
13 sections 857 and 858 of the Internal Revenue Code but with the
14 changes and adjustments made by this chapter (without prejudice
15 to the generality of the foregoing, for taxable years beginning
16 before January 1, 2018, the deduction for dividends paid is
17 limited to [~~such~~] the amount of dividends as is attributable to
18 income taxable under this chapter[~~)~~], and for taxable years
19 beginning after December 31, 2017, no deduction for dividends
20 paid shall be allowed), a tax consisting in the sum of the
21 following: 4.4 per cent if the taxable income is not over

1 $25,000, 5.4 per cent if over $25,000 but not over $100,000, and
2 on all over $100,000, 6.4 per cent. In addition to any other
3 penalty provided by law any real estate investment trust whose
4 tax liability for any taxable year is deemed to be increased
5 pursuant to section 859(b)(2)(A) or 860(c)(1)(A) after December
6 31, 1978, (relating to interest and additions to tax determined
7 with respect to the amount of the deduction for deficiency
8 dividends allowed) of the Internal Revenue Code shall pay a
9 penalty in an amount equal to the amount of interest for which
10 [~~such~~] the trust is liable that is attributable solely to [~~such~~]
11 the increase. The penalty payable under this subsection with
12 respect to any determination shall not exceed one-half of the
13 amount of the deduction allowed by section 859(a), or 860(a)
14 after December 31, 1978, of the Internal Revenue Code for [~~such~~]
15 that taxable year."
16 SECTION 4. Statutory material to be repealed is bracketed
17 and stricken. New statutory material is underscored.
18 SECTION 5. This Act shall take effect upon a date to be
19 determined and shall apply to taxable years beginning after
20 December 31, 2017; provided that on December 31, 2032, this Act
21 shall be repealed and sections 235-2.3(b) and 235-71(d), Hawaii

1 Revised Statutes, shall be reenacted in the form in which they
2 read on the day prior to the effective date of this Act.

H.B. NO. 1012 H.D. 1

Report Title:
Real Estate Investment Trusts; Deduction for Dividends Paid; Disallowed; Income Tax

Description:
Temporarily disallows the deduction for dividends paid by real estate investment trusts for a period of 15 years, but with an exception for dividends generated from trust-owned housing that is affordable to households with incomes at or below 140% of the median family income. (HB1012 HD1)

The summary description of legislation appearing on this page is for informational purposes only and is not legislation or evidence of legislative intent.

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

WRITTEN TESTIMONY OF

STEVEN A. WECHSLER
PRESIDENT & CEO
NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS
IN OPPOSITION TO H.B. 1012, H.D. 1

BEFORE THE HAWAII HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCE
HONORABLE SYLVIA LUKE, CHAIR
HONORABLE TY J.K. CULLEN, VICE CHAIR

HEARING ON H.B. 1012, H.D. 1

FEBRUARY 23, 2017
12:00 P.M.

1875 I Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.REIT.com

Chair Luke, Vice Chair Cullen, and members of the Committee on Finance,

The National Association of Real Estate Investment Trusts (NAREIT)[1] thanks you for this opportunity to submit testimony in **strong opposition** to H.B. 1012, H.D. 1, which would "temporarily" (for 15 years) eliminate the dividends paid deduction (DPD) for REITs except with respect to certain dividends from affordable housing.

NAREIT opposes H.B. 1012, H.D. 1, because it is contrary to federal income tax rules and the existing laws of virtually every other state with an income-based tax system. Enacting this proposal would double tax REITs and signal Hawaii's discouragement to long-term capital investment. This would potentially result in a reduction of millions of dollars of new REIT investment, a shift in property ownership to tax-exempt owners like pensions and endowments, and loss of revenue and significant jobs generated by REITs to the State. Accordingly, NAREIT respectfully asks this Committee to hold H.B. 1012, H.D. 1.

REITs are a way for people- including Hawaii residents and others – to own professionally-managed, rental real estate. Created by Congress in 1960, REITs are corporations that combine the investment dollars of many investors to own and operate rental properties that may include apartments (like Douglas Emmett's Waena Apartments, which provides workforce housing); theme parks (like CNL Lifestyle Properties' Wet'n'Wild Hawaii); shopping centers (like General Growth Properties' Ala Moana Center and Washington Prime Group's Pearlridge Center); hotels (like American Assets Trust's Embassy Suites at Waikiki Beach Walk), healthcare facilities (like Healthcare Realty Trust's Hale Pawaa medical office building), offices, and storage facilities. There are about 20 Securities and Exchange Commission (SEC)-registered REITs that have invested about $4 billion (as of Dec. 31, 2015) in over 70 Hawaii properties (worth approximately $7.7 billion, based on the equity market capitalization of all equity REITs in the FTSE NAREIT All REITs Index as of Dec. 31, 2015).

Unlike partnerships, LLCs or other C corporations, REITs are legally mandated to distribute all their taxable income to shareholders as dividends so their income is taxed once – at the shareholder level. In exchange for meeting this distribution requirement, federal law grants REITs a DPD. Like every other state with a corporate net income tax but New Hampshire, Hawaii follows federal law and allows a DPD. Thus, the income generated by REITs is reported by, and income taxes on such income are paid by, the shareholders of these companies to their state of residence. In fact, NAREIT's membership includes almost 200 public REITs and hundreds of REIT mutual funds invested in those REITs. Many of these REITs (and the funds that own these REITs) own **no properties** in Hawaii yet distribute millions of dollars in dividends – taxable by Hawaii – to thousands of Hawaii shareholders. Hawaii is able to tax these dividends even though the rental income underlying the dividends is earned in other states.

REITs benefit Hawaii by paying millions of dollars in taxes, creating jobs, and helping local communities. Hawaii economist Dr. Paul Brewbaker conducted a 2015 study on behalf of NAREIT that concluded that "[i]n just the past year REITs were associated with more than 11,700 jobs representing labor earnings of nearly $500 million and $95 million in tax revenue in Hawaii." In fact, REITs –like other commercial property owners - pay millions of dollars in general excise taxes (GET), property taxes and conveyance taxes. By investing hundreds of millions of dollars in property upgrades, their tenants generate even more in GET revenue. For example, Taubman's International Market Place (which opened last summer) is expected to pay in this current year over $1 million in

[1] NAREIT is the worldwide representative voice of real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets.

general excise tax and over $3 million in property taxes. Taubman also paid in total over $1.5 million in local conveyance taxes. The development of the center resulted in employment of over an estimated 1,000 construction jobs, and after opening is expected to create 2,500 permanent jobs (including employment by tenants).

If H.B. 1012, H.D. 1 were enacted, those REITs would be likely to modify their businesses to minimize double taxation and the anticipated Hawaii revenue, risking millions of dollars of capital investment and thousands of jobs. A new tax of 6.4% on net income in one state that does not exist in another state would encourage multi-state REITs to invest where the tax does not exist in order to maximize value to shareholders. The Department of Business, Economic Development and Tourism's (DBEDT) REIT study released in September 2016 specifically notes that its "estimates do not take into account how REITs would change their behavior if the DPD were repealed." For example, REITs may claim deductions or tax credits not currently claimed because currently the DPD fully offsets their income. At the same time, multi-state REITs likely would shift investments among the 48 states where double taxation is absent, and tax-exempt investors like pensions and endowments would fill the vacuum left by their departure and invest in more Hawaii real estate – resulting in no additional tax revenue for Hawaii.

H.B. 1012, H.D. 1 discourages investment in affordable housing. REITs with office buildings or retail properties in Hawaii currently are encouraged to build workforce housing so their tenants have places to live and shop. Limiting the DPD only to income from affordable housing lowers already low margins, discouraging further investment in affordable housing. Investors would view 15 years as permanent, and would shift capital to states without double taxation. In fact, we understand that at least one large REIT declined to invest in a sizable Hawaii project due to the mere threat of this legislation.

REITs are good for Hawaii: NAREIT urges this Committee to hold H.B. 1012, H.D. 1. Even though H.B. 1012, H.D. 1 purports to suspend the DPD temporarily (for 15 years) and exempt certain "affordable housing," its enactment would be tantamount to repeal. Except for New Hampshire, every other state that imposes a corporate-level income tax allows the DPD for widely-held REITs. Accordingly, NAREIT urges this Committee to hold H.B. 1012, H.D. 1.

To learn more about REITs in Hawaii, see NAREIT's www.theREITwayHawaii.com.

Filed 1/12/17

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIFTH APPELLATE DISTRICT

SWART ENTERPRISES, INC., Plaintiff and Respondent, v. FRANCHISE TAX BOARD, Defendant and Appellant.	F070922 (Super. Ct. No. 13CECG02171) **OPINION**

APPEAL from a judgment of the Superior Court of Fresno County. Kristi Culver Kapetan, Judge.

Kamala D. Harris, Attorney General, Paul D. Gifford and Diane Spencer Shaw, Assistant Attorneys General, Molly K. Mosley, Jane O'Donnell, and Craig D. Rust, Deputy Attorneys General, for Defendant and Appellant.

Silverstein & Pomerantz, Amy L. Silverstein, Edwin P. Antolin, and Edward J. Beeby for Plaintiff and Respondent.

-ooOoo-

INTRODUCTION

California's franchise tax is imposed on every corporation that is "doing business" within California, whether or not it is incorporated, organized, qualified, or registered

under California law. (Rev. & Tax. Code,[1] § 23151, subd. (a).) The phrase "doing business," for purposes of the franchise tax, means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." (§ 23101, subd. (a); see Cal. Code Regs., tit. 18, § 23101 (Regulation 23101).) The minimum liability for all corporations falling within the purview of section 23151 is $800 per year. (§ 23153, subd. (d)(1).)

The issue before us is whether the franchise tax applies to an out-of-state corporation whose sole connection with California is a 0.2 percent ownership interest in a manager-managed California limited liability company (LLC) investment fund. We conclude passively holding a 0.2 percent ownership interest, with no right of control over the business affairs of the LLC, does not constitute "doing business" in California within the meaning of section 23101. We affirm the judgment of the trial court.

FACTUAL AND PROCEDURAL HISTORY

This appeal is based on the parties' cross-motions for summary judgment. There are no material facts in dispute.

Swart Enterprises, Inc. (Swart), is a small family-owned corporation, incorporated in Iowa. Swart operates a 60-acre farm in Kansas, where it occasionally feeds cattle for beef sales in Nebraska. Its place of business and headquarters are located in Iowa. Swart has no physical presence in California, such as real or personal property, or employees; it does not sell or market products or services to California; and it is not registered with the California Secretary of State to transact interstate business.

In 2007, Swart invested $50,000 in Cypress Equipment Fund XII, LLC (Cypress LLC or the Fund) and became a member of the LLC. Swart's investment amounted to a 0.2 percent ownership interest. This is Swart's sole connection with California.

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[1]All undefined statutory citations are to the California Revenue and Taxation Code unless otherwise indicated.

Cypress LLC was formed as an LLC under California law in 2005 for purposes of acquiring, holding, leasing, and disposing of capital equipment. The LLC is manager-managed, as opposed to member-managed. Under Cypress LLC's articles of organization and operating agreement, the sole manager of the fund, Cypress Equipment Management Corporation III, was given "full, exclusive and complete authority in the management and control of the business of the Fund …."

Swart was not involved in any way in Cypress LLC's operations or management. In fact, "Members other than the Manager [were prohibited from taking] part in the control, conduct or operation of the Fund and [had] no right or authority to act for or bind the Fund." Thus, members had no authority to act as an agent, bind, execute an instrument on behalf of Cypress LLC, or to otherwise act in any way on its behalf.

In 2009 and 2010, Cypress LLC elected to be taxed as a partnership under federal and state law. During these same years, Cypress LLC was not required to pay taxes pursuant to section 18633.5, subdivision (e)(1) because the Fund had insufficient income.

In 2010, Swart passively held its 0.2 percent investment. However, based on its ownership interest in Cypress LLC, the Franchise Tax Board (FTB) demanded that Swart file a California corporate franchise tax return for the tax year ending June 30, 2010, and pay the $800 minimum franchise tax due on that return. Swart paid the tax, which amounted to $1,106 with penalties and interest, but contested it and requested a refund.

To be required to file a California corporation franchise tax return and pay the $800 minimum tax, Swart had to be incorporated in California, qualified to transact business in California, or actively doing business in California. (§ 23153, subds. (a), (b)(1)-(3).) The FTB concluded Swart was doing business in California based on the fact it held an ownership interest in Cypress LLC, and Cypress LLC had elected to be treated as a partnership for purposes of federal income taxes. The FTB explained under section 23101, "A foreign business entity (partnership, LLC, or corporation) is considered doing business in California if it is a member of an LLC that is doing business in California,"

and under section 23151, corporations doing business in the State of California must file a tax return and pay the annual minimum franchise tax of $800.

Swart claimed it was not subject to the franchise tax because it held no other investments in California, it did not otherwise do business in California, and it was only a passive member in Cypress LLC. Swart further claimed imposition of the franchise tax violated the due process clause and commerce clause of the United States Constitution. The FTB denied Swart's request for refund.

Swart timely filed a complaint seeking a tax refund and declaratory relief. After briefing and argument on the parties' cross-motions for summary judgment, the trial court entered an order granting Swart's motion for summary judgment and denying the FTB's motion for summary judgment. Swart was awarded a refund in the amount of $1,106.71.

On November 25, 2014, notice of entry of judgment was served.

On January 16, 2015, the FTB filed a timely notice of appeal.

ANALYSIS

I. Swart Was Not "Doing Business" in California

The Attorney General contends Swart was doing business in California because Cypress LLC elected to be treated as a partnership for federal income taxation purposes, and because Cypress LLC is doing business in California, so is Swart. We disagree.

Although this matter calls for our independent judgment, our views are substantially consistent with the trial court's ruling, which we find to be logical and well-reasoned. We are not persuaded Swart may be deemed to be doing business in California because it owns a 0.2 percent interest in a manager-managed LLC doing business in California. Swart's only connection to California was a mere 0.2 percent ownership interest it *passively* held during the tax year the franchise tax was imposed. This interest closely resembled that of a limited, rather than general, partnership as evinced by the fact

Swart had no interest in the specific property of Cypress LLC, it was not personally liable for the obligations of Cypress LLC, it had no right to act on behalf of or to bind Cypress LLC and, most importantly, it had no ability to participate in the management and control of Cypress LLC. Because the business activities of a partnership cannot be attributed to limited partners (*Appeals of Amman & Schmid Finanz AG* (1996) 96 SBE 008 [1996 Cal. Tax LEXIS 62] (*Amman & Schmid*)), Swart cannot be deemed to be "doing business" in California solely by virtue of its ownership interest in Cypress LLC.

A. Standard of Review

The interpretation and application of a tax statute to uncontradicted facts is a pure question of law, which we review de novo. (*Communications Satellite Corp. v. Franchise Tax Bd.* (1984) 156 Cal.App.3d 726, 746.) We also review de novo the grant of a motion for summary judgment, particularly where issues of statutory interpretation and constitutional claims are presented. (*Penrod v. County of San Bernardino* (2005) 126 Cal.App.4th 185, 189.)

B Discussion

1. Swart Was Not "Doing Business" in California Under the Plain Language of Section 23101 and Regulation 23101

California's franchise tax is imposed on the net income of every corporation "doing business within the limits of this state." (§ 23151, subd. (a).) For tax years prior to January 1, 2011, section 23101 defined "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."[2] (Former § 23101, now § 23101, subd. (a).) The term "actively" is the opposite of "passively" or

---

[2]This definition was designated as subdivision (a) of amended section 23101. (Stats. 2009-2010, 3d Ex. Sess., ch. 10, § 7, eff. Feb. 20, 2009.) For tax years beginning on or after January 1, 2011, a taxpayer is also "doing business" in California if the taxpayer is organized or commercially domiciled in California, or a taxpayer's California sales, property, or payroll exceed the amounts applicable under subdivision (b)(1) of section 23101. Because the franchise tax was imposed for Swart's tax year ending June 30, 2010, these new bases for "doing business" do not apply to Swart.

"inactively" and means "active transaction for pecuniary gain or profit." (*Golden State Theatre & Realty Corp. v. Johnson* (1943) 21 Cal.2d 493, 496 (*Golden State Theatre*); *Hise v. McColgan* (1944) 24 Cal.2d 147, 151.) For example, "the purchase and sale of stocks or bonds" may constitute doing business within the meaning of section 23101, but "[t]he mere receipt of dividends and interest by a corporation and the distribution of such income to its shareholders does not." (Regulation 23101, subds. (a), (b).)

Here, the $800 minimum franchise tax was imposed upon Swart several years after Swart made its investment and became a member of Cypress LLC. We are not persuaded such an investment, without more, is sufficient to conclude Swart was doing business in California. Like a shareholder's receipt of dividends and interest, Swart merely passively held onto its investment in the tax year the franchise tax was imposed.

Nonetheless, citing to *Golden State Theatre*, *supra*, 21 Cal.2d 493, the Attorney General claims the term "doing business" should be interpreted broadly to include Swart's passive investment. There, according to the Attorney General, our Supreme Court held that "an out-of-state taxpayer's passive investment in California was a transaction for pecuniary gain or profit, so the resulting dividends were subject to California tax."

Golden State Theatre does not suggest the term "doing business" should be interpreted broadly. There, the plaintiff, Golden State Theatre and Realty Corporation, owned a 50 percent share of stock in a corporation, East Bay Theatres, Inc., which in turn owned a 100 percent share of stock in two other corporations. (*Golden State Theatre*, *supra*, 21 Cal.2d at p. 494.) The plaintiff argued dividends received from its ownership interests were deductible from its gross income as "'dividends received during the income year from a … corporation doing business in this State declared from income arising out of business done in this State ….'" (*Ibid.*)

The issue was whether East Bay Theatres, Inc., was merely a holding company or whether it was doing business in California, which would entitle the plaintiff to claim the

deductions. (*Golden State Theatre*, *supra*, 21 Cal.2d at p. 494.) The defendant argued the entity was not actively engaged in any transaction because East Bay Theatres, Inc., was not established to operate a business, but to acquire property and derive income from properties, which did not even occur regularly. (*Id*. at p. 495.) Our Supreme Court concluded the activities conducted by East Bay Theatres, Inc., demonstrated it was "doing business," because it had *actively engaged* in multiple transactions for pecuniary gain. (*Id*. at p. 496.) Specifically, it undertook the following activities: endorsing a note of a subsidiary, borrowing funds, purchasing, owning and renting property, collecting rents, giving notices to quit, and arranging for improvements to property. (*Id*. at p. 495.)

Golden State Theatre illustrates the distinction between "actively," and "passively" or "inactively" engaging in business transactions. It does not suggest the term "doing business" should be read broadly.

2. There Is No Authority to Support the Conclusion Cypress LLC's Taxation Election Rendered Swart a General Partner of Cypress LLC

The Attorney General further contends Swart was a general partner of Cypress LLC based on an election by Cypress LLC to be treated as a partnership for purposes of federal income taxes. According to the Attorney General, if Cypress LLC is treated as a partnership, then Swart is a general partner of the LLC, and Swart can therefore be imputed with "doing business" in California because Cypress LLC was doing business in California. This is because the activities of a partnership can be attributed to a general partner. We are not persuaded Swart's interest in Cypress LLC was transmuted into a general partnership interest for purposes of the franchise tax.

A taxation election refers to a business entity's ability to choose its classification for federal income tax purposes by making a check-the-box election. (26 C.F.R. §§ 301.7701–1 through 301.7701–3 (2017) [check-the-box regulations].) LLC's are not recognized as an entity choice for federal or California tax law purposes. (See 26 C.F.R.

§ 301.7701–2 (2017); § 23038, subd. (b)(2)(B)(ii), (iii); see also Cal. Code Regs., tit. 18, § 23038(b)-3, subd. (c).) Accordingly, for tax purposes, a multiple-member LLC can elect to be treated as either a partnership or a corporation under the check-the-box election regulations. California tax law conforms to the federal entity classification election system by mandating that an eligible entity be either classified or disregarded[3] for California tax purposes, just as it is for federal tax purposes. (See § 23038, subd. (b)(2)(B)(ii), (iii); Cal. Code Regs., tit. 18, § 23038(b)-3, subd. (c).)

The Attorney General asserts an LLC member is rendered a general partner of the LLC as a result of an LLC's election to be treated as a partnership for federal taxation purposes. We are not directed to any legal authority to support this conclusion. The trial court identified this same deficiency in the Attorney General's motion below, but the error was not corrected on appeal. We note the Treasury Regulations (26 C.F.R. §§ 301.7701-1, 301.7701-2 & 301.7701–3 (2017)) do not address whether an LLC making a partnership election is considered a general partnership or a limited partnership for federal tax purposes, or whether LLC members are considered general or limited partners.

Nonetheless, relying on the assumption Swart owns a general partnership interest in Cypress LLC and that this classification is relevant for purposes other than the computation of income taxes, the Attorney General directs us to Internal Revenue Code section 702. Internal Revenue Code section 702 provides that for federal income tax purposes, the character of an item of income, gain, loss, deduction, or credit included in a partner's distributive share is be determined at the partnership level, i.e., "as if such item

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[3]A "disregarded entity" refers to an entity that is separate from its owner, but elects to be disregarded as an entity separate from its owner for tax purposes. Thus, a single-member LLC classified as a disregarded entity will be treated as a sole proprietorship on the LLC owner's tax return. (Comment, *The Federal Tax Personality of Disregarded LLCs [Littriello v. United States, 484 F.3d 372 (6th Cir. 2007)]* (2007) 47 Washburn L.J. 203, 218.)

were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." (Int.Rev. Code, § 702(b).)

The Attorney General ostensibly directs us to Internal Revenue Code section 702 to make the following point: wherever the partnership does business, the activities of the partnership are attributed to each partner, whether general or limited, with the consequence that in locations where the partnership is doing business, the partners are also doing business. This is because a partner is recognized as deriving a share of partnership income and loss from the place where the partnership transacts its business.

To explain why this conclusion is flawed, we first examine the Attorney General's claim that a taxation election is relevant for purposes other than federal income taxes. The plain language of the check-the-box regulations provides that a taxation election applies for "federal tax purposes" and not just for "federal *income* tax purposes." (26 C.F.R. § 301.7701–1(a)(1) (2017).) The absence of language of limitation suggests the LLC's election is relevant for tax purposes beyond the computation of federal income taxes.

Swart disagrees and contends an LLC is a separate entity from its owners, and an LLC's decision to be taxed as a partnership for federal income taxes does not mean the LLC's separate entity status may be disregarded for all taxation purposes, including the franchise tax. Swart directs us to *Pierre v. Comm'r* (2009) 133 T.C. 24 (*Pierre*) on this point.

In *Pierre, supra*, 133 T.C. 24, the United States Tax Court considered whether the check-the-box regulations altered the federal gift tax valuation regime. (*Id*. at pp. 26-27.) The taxpayer was a New York resident who wanted to give money to her son and granddaughter. (*Id*. at p. 25.) To ensure the family's wealth stayed intact, the taxpayer formed a single-member LLC, created trusts for both her son and granddaughter, and transferred $4.25 million in cash and securities to the LLC in exchange for a 100 percent interest in the entity. (*Ibid*.) The taxpayer then transferred a 9.5 percent interest in the

LLC to each trust, and sold each of the trusts a 40.5 percent interest in the LLC in exchange for promissory notes. (*Ibid*.) The taxpayer paid gift tax in the amount of $256,168 per transfer, the value of the interests transferred after discounts for lack of marketability and lack of control. (*Id*. at p. 26.) The Internal Revenue Service claimed because the LLC was a disregarded entity, which is indistinguishable from its owner, the taxpayer should have valued the gift as a transfer of the underlying assets, minus the value of the promissory notes, which would have amounted to a substantially greater tax burden. (*Ibid*.)

The tax court held that although a single-member LLC was treated as a disregarded entity under the federal check-the-box regulations, that designation did not control the valuation of the LLC interests transferred for federal gift tax purposes. (*Pierre, supra*, 133 T.C. at p. 35.) According to the tax court, state laws applicable to the LLC controlled the legal rights of the parties, not the LLC's taxation election, and the legal relationships between the parties justified discounts for lack of control and marketability. (*Ibid*.)

The Attorney General argues *Pierre* is distinguishable because there, a single-member LLC was at issue, and a single-member LLC cannot elect to be treated as a partnership for tax purposes. The Attorney General's argument misses the point. *Pierre* stands for the proposition that a taxation election may not control for all taxation purposes in all circumstances.

Assuming, arguendo, that a taxation election is relevant for purposes of determining whether an LLC member is doing business in California under section 23151, the Attorney General's conclusion is flawed for one other significant reason: it draws no distinction between general and limited partnership interests. The State Board of Equalization (SBE) has previously recognized a limited partner is not "doing business" merely by virtue of its ownership interest in a limited partnership.

In *Amman & Schmid, supra*, 96 SBE 008 [1996 Cal. Tax LEXIS 62], the appellants, foreign corporations, acquired limited partnership interests in descending tiers of limited partnerships. The bottom tier of the partnerships were indisputably doing business in California. The FTB claimed the appellants were also "doing business" in California under section 23101 because the general partners were executing business transactions in California as agents for the limited partnerships and all the partners. The corporate limited partners challenged this finding, because "doing business" requires "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." (*Id.*, subd. (a).) While section 23101 does not require a regular course of business, "it nevertheless does require active participation in the profit-seeking activity, and limited partners are necessarily passive or inactive members of the partnership." (*Amman & Schmid, supra*, at p. 3 [1996 Cal. Tax LEXIS 62 at p. *5].)

The SBE noted that under the California Revised Limited Partnership Act (Corp. Code, tit. 2, ch. 3), the foreign corporations, as limited partners, were not liable for the obligations of the partnerships (*id.*, former § 15632), they could not act on behalf of the partnership, had no interest in specific property of the partnership (*id.*, former § 15671), and their ownership interests included only intangible property, which is ordinarily located at the domicile of the limited partner. (*Amman & Schmid*, *supra*, 96 SBE 008 at p. 4 [1996 Cal. Tax LEXIS 62 at pp. *8-9], citing *Appeals of Amyas and Evelyn P. Ames et al.* (1987) 87 SBE 042.) The SBE concluded the corporate limited partners could not be doing business in California simply because they owned interests as limited partners in partnerships engaged in business in California because "[a] general partner simply does not have agency rights over the obligations or the property of the limited partners." (*Amman & Schmid*, *supra*, at p. 4 [1996 Cal. Tax LEXIS 62 at p. *9].)

The SBE noted it had previously concluded otherwise. In *Appeal of H.F. Ahmanson & Company* (1965) 65 SBE 013 [1965 Cal. Tax LEXIS 38], (*H.F. Ahmanson*), the SBE concluded the source of a limited partner's income or loss from the partnership

is where the partnership property is located and the partnership activity is carried on. (*Id.* at p. 3 [1965 Cal. Tax LEXIS 38 at p. *4.) As a result, partnership losses were determined to be sourced in Turkey and not in California, because the partnerships were regularly engaged in business in Turkey and the appellant, a limited partner, was therefore also engaged in business in Turkey. In *Amman & Schmid*, the SBE changed its position, explaining, "This observation is arguably true for general partnerships. But … more specific examination has convinced us … this … is not necessarily true for limited partners." (*Amman & Schmid*, *supra*, 96 SBE 008 at p. 4 [1996 Cal. Tax LEXIS 62 at p. *11].)

Amman & Schmid strongly supports the conclusion Swart was not doing business in California. Like the limited partners in *Amman & Schmid*, Swart had no interest in the specific property of Cypress LLC (Corp. Code, former § 17300), it was not personally liable for the obligations of Cypress LLC (*id.*, former § 17101, subd. (a)), it had no right to act on behalf of or bind Cypress LLC (*id.,* former § 17157, subd. (b)(1), (2)), and Swart was prohibited from participating in the management and control of Cypress LLC.

The Attorney General claims *Amman & Schmid* is distinguishable because it examined limited partnerships exclusively, rather than LLC's, when it concluded "doing business" requires an active role in a limited partnership, rather than a passive investment in a limited partnership. The Attorney General further contends *Amman & Schmid* "does not even acknowledge that limited partnerships can elect to be treated as general partnerships for purposes of franchise income taxation."

We are perplexed by these arguments. If an LLC's taxation election renders the LLC and its members partners for all taxation purposes, then no meaningful distinction can be drawn between the limited partnership interests in *Amman & Schmid* and Swart's partnership interest.[4] Although it is unclear to us what the Attorney General means by

[4]The Attorney General directs us to a number of cases purportedly recognizing that the activities of a partnership are attributed to each partner, such that the partners are doing business

stating a "limited partnership[] can elect to be treated as [a] general partnership[]" for income tax purposes, we are not directed to any legal authority to support the conclusion that an LLC's taxation election automatically transmutes LLC members into general partners for tax purposes relevant to this appeal. As we explain below, Swart's partnership interest was akin to a limited rather than general partnership interest.

3. Swart's Interest in Cypress LLC Was Comparable to a Limited Partnership Interest

Swart contends that like a limited partner, it was merely a passive investor, and it had no right to manage or control the business operations of Cypress LLC. On this basis, it asserts it cannot be deemed to be "doing business" in California solely by virtue of holding a membership interest in an LLC doing business in California. We agree.

Members in an LLC have limited liability for the company's debts and obligations (*Kwok v. Transnation Title Ins. Co.* (2009) 170 Cal.App.4th 1562, 1571), and members hold no direct ownership interest in the company's specific property. (Corp. Code, former § 17300.) Similarly, "A limited partner's interest in [a] partnership is intangible

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where the partnership is doing business. None of these cases answer the question of whether a foreign entity such as Swart may be deemed to be "doing business" in California for purposes of the franchise tax, by virtue of its ownership interest in a California manager-managed LLC doing business in this state. (See *Appeal of John Manter* (1999) 99 SBE 008 [1999 Cal. Tax LEXIS 500] [nonresident taxpayer contested tax based on pass-through income from California source of an S corporation].) Moreover, many of these cases rely on outdated authority which held that partnerships are not regarded as separate legal entities for purposes of owning property. (See *H.F. Ahmanson*, *supra*, 65 SBE 013 [1965 Cal. Tax LEXIS 38] [limited partner in California partnership engaged in activities in Turkey denied California deductions for losses resulting from partnership activities in Turkey where general partner was held to be an agent of the limited partner, and general and limited partners are owners of partnership's property]; *Appeal of Estate of Marion Markus* (1986) 86 SBE 097 [1986 Cal. Tax LEXIS 136] [relying on *H.F. Ahmanson*, nonresident taxpayer's income from California limited partnership held to be from California, where property of partnership was located and where partnership's activities were carried on]; *Appeal of Lore Pick* (1985) 85 SBE 066 [1985 Cal. Tax LEXIS 112] [same]; *Appeal of Custom Component Switches, Inc.* (1977) 77 SBE 009 [1997 Cal. Tax LEXIS 110] [relying on *Ahmanson*, California corporation denied deductions arising from losses attributable to partnership property located outside California].) One additional case we are directed to is unpublished authority and may not be cited or relied upon. (*Appeal of CFL, LP* (2014) case No. 764609 [nonpub. opn.].)

personal property, which ordinarily is located in the domicile of the limited partner." (*Amman & Schmid*, *supra*, 96 SBE 008 at p. 4 [1996 Cal. Tax LEXIS 62 at pp. *8-9], citing *Appeals of Amyas and Evelyn P. Ames et al.*, *supra*, 87 SBE 042.) Although members of an LLC may generally participate in the management and control of the business (*PacLink Communications Internat.*, *Inc. v. Superior Court* (2001) 90 Cal.App.4th 958, 963), whereas limited partners risk losing their limited liability protection by doing so (Corp. Code, § 15903.03, subd. (a)), this ability ultimately depends on how management is vested within the parties' operating agreement and articles of incorporation.

Relations among members and the LLC are governed by its articles of incorporation and operating agreement. (Corp. Code, former § 17005, subd. (a), as amended by Stats. 1996, ch. 57, § 5, and repealed by Stats. 2012, ch. 419, § 19, operative Jan. 1, 2014.) Where an LLC is established as a manager-managed LLC, "any matter relating to the activities of the limited liability company is decided exclusively by the managers." (Corp. Code, § 17704.07, subd. (c)(1).) While LLC members have the ability to remove the manager with a majority vote (*id.*, subd. (c)(4), (5)), they have no right to control the management and conduct of the LLC's activities, nor do they have the apparent authority to do so (see Corp. Code, § 17703.01, subd. (a) [every member of a member-managed LLC is an agent of the LLC for the purpose of its business or affairs].)

Here, the operating agreement executed by Cypress LLC and its members established the Fund as a manager-managed LLC. The operating agreement gave the manager "'full exclusive and complete authority in the management and control of the business of the Fund for the purposes [stated in the Operating Agreement] and [made] all decisions affecting the fund.'" The specific matters upon which Cypress LLC members were authorized to act did not empower members to manage or control Cypress LLC. In fact, the agreement expressly prohibited "[m]embers other than the Manager [from taking] part in the control, conduct or operation of the Fund and [had] no right or

authority to act for or bind [Cypress LLC]." The Attorney General does not contend Swart acted outside of the operating agreement.

Thus, the relationship between Cypress LLC and Swart supports the conclusion Swart was a quintessential passive investor. Swart had no authority to participate in the management and control of the Fund, it was not liable for the debts and obligations of the Fund, it did not own an interest in specific property of the Fund, nor could it act on behalf of the Fund. Under these circumstances, Swart's interest in Cypress LLC was akin to that of a limited partner, and it cannot be deemed to be "doing business" in California by virtue of the fact Cypress LLC was "doing business" in California.

The Attorney General contends members of an LLC are themselves doing business in California by virtue of their ownership interest in the LLC, whether or not they are members of a member-managed LLC or a manager-managed LLC. It appears this conclusion was derived from a legal ruling issued by the FTB during the pendency of litigation in this matter. (Cal. Franchise Tax Bd., Legal Ruling No. 2014-01 (July 22, 2014) [2014 Cal. FTB LEXIS 2].) To the extent the arguments on appeal were also derived from the FTB's legal ruling, we disagree with its analysis and note it contradicts the position previously taken by the FTB.[5]

In its legal ruling, the FTB discussed a hypothetical assuming a California LLC is "doing business" in California. The FTB concluded that a member corporation holding a 15 percent interest in an LLC, not incorporated, organized, or registered to do business in

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[5]In its Technical Advice Memorandum No. 200658 (Dec. 22, 2000) (TAM) [2000 Cal. FTB TAM LEXIS 28], the FTB's legal department concluded, "For purposes of doing business, [where an out-of-state LLC member] is a separate entity and receives California source income from [the LLC,] [t]he [out-of-state LLC member] is not considered to be doing business in California." The out-of-state corporation was still subject to California income tax, absent an exemption application, but it was not subject to the corporation franchise tax fee because it was not "doing business" in California. In the TAM, the FTB relied on *Amman & Schmid*, *supra*, 96 SBE 008 at page 2 [1996 Cal. Tax LEXIS 62 at p. *3], noting it had previously concluded a foreign corporation, which was a limited partner in a California partnership, was not doing business in California.

California, and with no presence in California other than its membership in the LLC, must nonetheless file a return and pay all taxes and fees resulting from its membership interest in the LLC. (Cal. Franchise Tax Bd., Legal Ruling No. 2014-01, *supra*, at p. 9 [2014 Cal. FTB LEXIS 2 at p. *21].) The FTB explained because the LLC is classified as a partnership for tax purposes and is doing business in California, all of its members are also doing business in California. (*Id*. at p. 3 [2014 Cal. FTB LEXIS 2 at p. *7].) According to the FTB, even a member of a manager-managed LLC is doing business in California, provided the LLC is itself doing business in California:

> "Members of LLCs generally have the right to participate in the management of the business. Part of that power necessarily includes the right to delegate the power to manage the business in favor of a manager, and the power to revoke that delegation at any time. This analysis is not affected by whether or not members participate in the management of an LLC or appoint a manager to do so because the members' rights to participate in the management of the business arise out of the statutory relationship between an LLC and its members…. *'The courts have recognized that the execution of an agreement relinquishing control is itself an exercise of the requisite right of control over the conduct of the partnership business.'* Thus, the distinction between 'manager-managed' LLCs and 'member-managed' LLCs is not relevant for purposes of determining whether a member of an LLC, which is 'doing business' in California and is classified as a partnership for tax purposes, is 'doing business' here within the meaning of Section 23101." (Cal. Franchise Tax Bd., Legal Ruling No. 2014-01, *supra*, at p. 4 [2014 Cal. FTB LEXIS 2 at pp. *9-*10], italics added, fns. omitted.)

The FTB asserts members in manager-managed LLC's have the right to exercise some control over the LLC because they relinquish control of the LLC to the manager, and they have the authority to remove the manager at any time. Applying this logic to the instant matter, the Attorney General argues that members of Cypress LLC, including Swart, had the right to control the Fund, notwithstanding the fact it was manager-managed. The FTB directs us to *Moulin v. Der Zakarian* (1961) 191 Cal.App.2d 184, 190 (*Moulin*) for the proposition that "[t]he execution of an agreement relinquishing

control of the partnership is itself an exercise of the requisite right of control over the conduct of the partnership business."

The FTB's reliance on *Moulin* is unavailing. The issue before the Court of Appeal in *Moulin* was whether payments made under an alleged partnership agreement constituted investments in a security, which could not lawfully be sold without a permit. (*Moulin, supra*, 191 Cal.App.2d at pp. 185–186.) The defendant asserted the agreement at issue was intended to be a general partnership agreement, and because all contributions constituted contributions to the capital of the partnership, no permit was required because no interest was sold to the public. (*Id.* at p. 188.) The Court of Appeal held, based on the *totality* of the rights and obligations established under the agreement, a general partnership was formed. (*Id.* at p. 191.) The fact that the agreement designated managerial control to the defendant was only one of the factors the court relied on in concluding the agreement was a partnership agreement.

Here, unlike *Moulin*, Swart cannot be said to have exercised any right of control by relinquishing control of Cypress LLC to a manager, because it never had this right to begin with. As the trial court explained, the Attorney General's argument fails to acknowledge Cypress LLC was established as a manager-managed LLC two years before Swart became an investor. Cypress LLC was formed in 2005 and Swart did not become an investor until 2007. Swart had no right to control or influence the designation of Cypress LLC as a manager-managed fund. This designation was made two years before Swart made its investment in Cypress LLC. Nor is there any basis from which it could be reasonably inferred that Swart could have exercised influence over this decision in light of the fact its ownership interest was merely 0.2 percent.[6]

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[6]In any event, we note limited partners are vested with a similar right. Pursuant to Corporations Code section 15904.01, subdivision (d), an individual may become a general partner "with consent of all the partners." In so doing, a limited partner does not lose its limited partnership status.

Further, while LLC members retain the right to remove the manager, this action can only be taken by a majority vote. (See Corp. Code, former §§ 17150-17152, added by Stats. 1994, ch. 1200, § 27, and repealed by Stats. 2012, ch. 419, § 19, eff. Jan. 1, 2014; on or after Jan. 1, 2014, see Corp. Code, § 17704.07, subd. (c)(5).) Swart could not have removed the manager on its own, and in light of its minimal ownership interest, it would have had only a minimal influence upon the majority's decision in this regard. We decline to hold that such a limited power, conditioned upon the consent of the majority, could give an LLC member the right to manage or control the decision-making process of the LLC, particularly where this right was never exercised.[7]

We conclude Swart was not doing business in California based solely on its minority ownership interest in Cypress LLC. The Attorney General's conclusion that a taxation election could transmute Swart into a general partner for purposes of the franchise tax, and that the business activities of Cypress can therefore be imputed to Swart, is not supported by citation to appropriate legal authority and, in our view, defies a commonsense understanding of what it means to be "doing business."

II. Swart's Constitutional Challenges to Imposition of the Franchise Tax

Bearing in mind that a reviewing court should consider a constitutional question only where essential to the disposition of a case, we do not reach Swart's challenge to the franchise tax on constitutional grounds as it was not necessary to the disposition of this

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[7] At oral argument, the Attorney General argued members of an LLC have an intrinsic right to participate in the management of the LLC, even if that right is bargained away. We disagree. "Relations among members and between members and the [LLC] are governed by the articles of organization and operating agreement." (Corp. Code, former § 17005, subd. (a).) Where the parties' operating agreement designates the LLC as manager-managed and expressly prohibits the non-managing LLC member from participating in the management and control of the LLC, it cannot be said that the member has any such right, intrinsic or otherwise. Although we can envision circumstances where the parties' conduct may evince an LLC member's participation in the control of the LLC, notwithstanding restrictions set forth in the operating agreement, such circumstances are not present here. As noted, the parties do not contend Swart actually participated in the management or control of Cypress LLC's business activities.

matter. "It is not the habit of the court to decide questions of a constitutional nature unless absolutely necessary to a decision of the case." (*Burton v. United States* (1905) 196 U.S. 283, 295.)

DISPOSITION

The judgment is affirmed. Respondent shall recover its costs on appeal.

PEÑA, J.

WE CONCUR:

HILL, P.J.

DETJEN, J.