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MULTISTATE INCOME/FRANCHISE TAX

California Franchise Tax Board opines on pass-through entity structures that may be in a unitary relationship

Tax Alert

Overview

The California Franchise Tax Board ("FTB") recently issued a Legal Ruling ("Ruling 2021-01")[1] that provides its view regarding circumstances in which pass-through holding companies may be considered unitary with pass-through operating companies. Ruling 2021-02 provides five examples to illustrate how the unitary determination is made in this context.

This Tax Alert provides a high-level summary of the key highlights from Ruling 2021-01 and some taxpayer considerations.

Key highlights and taxpayer considerations

Ruling 2021-01 explains that a unitary determination in the context of pass-through holding companies requires additional consideration that may differ from a traditional unity analysis – specifically, the fact that holding companies have limited, if any, operations means that other non-traditional factors are more heavily weighted in determining unity.[2] Those factors may include insulation from liability, intercompany financing, shared tax benefits, improved creditworthiness, covenants not to compete, holding company control of the operating company, and any other benefits to the operating business from the holding company. Through five examples, Ruling 2021-01 highlights the following positions of the FTB:

- Limited partners are generally not considered unitary with a limited partnership, because limited partners are typically passive investors with no managerial or operational control over the operations of the limited partnership. (*See* Example 5 of Ruling 2021-01).

- General partners of a limited partnership are properly presumed unitary with the limited partnership, because they have control over the partnership's operations. (*See* Example 5 of Ruling 2021-01).

- LLCs are viewed differently than limited partnerships for purposes of determinining whether a unitary relationship exists between an LLC and its members.[3] Any member, whether a managing member or otherwise, may be unitary with an LLC if the member has or exercises control of the LLC, by reasons of majority ownership or otherwise.

- When a pass-through holding company has majority ownership and control (e.g., by way of voting rights) over a limited liability company ("LLC") that is a pass-through operating company, this fact, alone, is sufficient to support a finding of unity under the contribution or dependency test, even if the holding company does not actually exercise day-to-day management control over the LLC. (*See* Example 1 of Ruling 2021-01). This position is arguably inconsistent with precedential court cases, as well as California administrative decisions, that recognize the mere potential for control is insufficient to support a unitary determination.[4]

- The actual exercise of control by a pass-through holding company (including through an unrelated third-party hired by that pass-through holding company) over the day-to-day operations of an LLC that is a pass-through operating company is sufficient to support a unitary determination (unless the taxpayer establishes otherwise), even if the holding company holds a minority interest and minority voting rights in the LLC. (*See* Examples 1, 2, and 3 of Ruling 2021-01). However, if the holding company holds a minority interest and minority voting rights, and there is no evidence that the holding company has any control over the LLC and its managers and operations, the holding company is not unitary with the LLC. (*See* Example 1 of Ruling 2021-01).

- If an upper-tier operating partnership ("Upper-Tier OpCo") utilizes an intermediate pass-through holding company solely to hold an interest in a non-unitary operating partnership ("Lower-Tier OpCo"), and Upper-Tier OpCp and Lower-Tier OpCo are distinct businesses and share no operational integration, the purpose of the holding company is to further an investment objective of Upper-Tier OpCo. Because the holding company's investment purpose attaches to the relationship between the Upper-Tier OpCo and the holding company and between the holding company and the Lower-Tier OpCo, the three entities are not unitary. (*See* Example 4 of Ruling 2021-01).

The impact of Ruling 2021-01 can be seen, for example, in the context of a non-resident individual who indirectly owns an interest in an operating partnership or LLC ("Operating Company") through a holding company partnership, LLC or S corporation ("Holding Company"). If the Holding Company sells its interest in the Operating Company, the California personal income tax consequences to the non-resident individual may differ markedly, depending on whether the two entities are unitary. If a unitary relationship exists, the gain recognized by the Holding Company from the sale of its interest in the Operating Company could potentially be regarded as business income. In such case, non-resident individual could be subject to California personal income tax on his distributive share of the income apportioned to California. However, absent a unitary relationship, the gain recognized by the Holding Company from the sale of its interest in the Operating Company could be sourced entirely outside California to the non-resident individual's state of residence, unless the non-resident individual's indirect interest in the Operating Company had acquired a business situs in California (pursuant to Cal. Rev. & Tax Code § 17952).[5]

Taxpayers should consult their tax advisors to analyze the manner in which Ruling 2021-01 may impact their California tax liabilities and consider the potential implications of Ruling 2021-01 in future tax planning.

Get in touch

Roburt Waldow
Chris Campbell
Greg Bergmann
Shirley Wei
Mark Chao
Todd Hyman
Kathy Freeman
Tien Do
Bart Baer
Jairaj Guleria
Farah Raja

Footnotes

[1] Cal. Franchise Tax Bd., Legal Ruling No. 2021-0 (Oct. 25, 2021).
[2] Ruling 2021-01 relies primarily on California State Board of Equalization decisions – *Appeal of PBS Building Systems, Inc. and PKH Building Systems, Inc.*, 94-SBE-008 (Nov. 17, 1994), and *Appeal of Fibreboard Corporation*, 87-SBE-002 (Jan. 6, 1987) – and a Tennessee Supreme Court decision, *Blue Bell Creameries LP v. Roberts*, 333 S.W. 3d 59 (2011) for its conclusions.
[3] *Cf.* Legal Ruling 2021-01, *with e.g., Appeal of Satview Broadband Ltd,* OTA Case No. 18010756 (Sept. 25, 2018), *and Appeal of Wright Capital Holdings LLC*, OTA Case No. 18010842 (Aug. 21, 2019).
[4] For example, there must be evidence that the subject individuals or entities actually contributed to the integration of the operations of the business, beyond what would normally be expected in any parent-subsidiary or investor-investee relationship, in order for there to be a unitary relationship. *See e.g., F.W. Woolworth v. Taxation & Rev. Dep't of N.M.,* 458 U.S. 354 (1982); *F.W. Woolworth Co. v. Franchise Tax Bd.,* 160 Cal. App. 3d 1154 (1984); *Tenneco West v. Franchise Tax Bd.,* 234 Cal. App. 3d 1510 (1991); *Appeal of C.H. Stuart Inc.,* 84-SBE-155 (Nov. 14, 1984); *Appeal of J.B. Torrance Inc.,* 85-SBE-048 (May 8, 1985); *Appeal of Santa Anita Consolidated,* 84-SBE-056 (Apr. 5, 1984); *Appeal of Meadows Realty,* 90-SBE-052 (Mar. 31, 1982); *Appeal of Hollywood Film Enterprises Inc.,* 82-SBE-052 (Mar. 31, 1982).
[5] There is also the view that, regardless of whether Upper-Tier Pass-Through and Lower-Tier Pass-Through are unitary, the subject gain should be sourced under Cal. Rev. & Tax Code § 17952. *See e.g., The 2009 Metropolous Family Trust et. al. v. Franchise Tax Board,* Case No. D078790 (Cal. Ct. App. 2021); *Appeal of Faries,* OTA Case No. 18043049 (Cal. Office of Tax App. argued Sept. 29, 2021).

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30 Rockefeller Plaza
New York, NY 10112-0015
United States

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