

California Registration Requirements For Foreign LLCs

By Jacob Stein¹

I. INTRODUCTION

The question of California registration comes up often when foreign limited liability companies are used as holding companies for California legal entities, or own passive assets in California like bank accounts and non-income producing real estate. In Publication 3556, and in practice, the FTB has adopted a position that virtually every foreign limited liability company, especially one with a California resident manager or managing members, should register with California and pay California taxes.

California's jurisdiction to require an out-of-state limited liability company to register as a foreign limited liability company with the State of California is limited by the Due Process Clause of the 14th Amendment and the dormant Commerce Clause.²

II. CALIFORNIA NEXUS REQUIRED

Under the Due Process clause, California must show that the foreign limited liability company has "minimum contacts" with California.³ Under the dormant Commerce Clause, California must establish a "substantial nexus" between the foreign limited liability company and California.⁴

Both of these tests are commonly referred to as the "nexus requirement." It has been interpreted by some courts to mean that if the state lacks the "definite link" or "minimum connection" with the taxpayer or its activities, it has not "given anything for which it can ask return."⁵

Even if a foreign LLC satisfies the nexus requirements of the Due Process Clause or the dormant Commerce Clause that would only allow California to subject that foreign LLC to its income tax jurisdiction, having nexus with California would not be sufficient alone to require the foreign LLC to register with the State of California or to be liable for franchise taxes in California.

III. TRANSACTING BUSINESS IN CALIFORNIA

California imposes a registration requirement on foreign LLCs only if they transact business within California: "Before transacting intrastate business in this state, a foreign limited liability company shall register with the Secretary of State."⁶

The term "transact intrastate business" is defined as entering into repeated and successive transactions of business in California, other than in interstate or foreign commerce.⁷

Being a member or a manager of a California LLC or a foreign LLC, in itself, is excluded from the meaning of "transact intrastate business."⁸ Similarly excluded are (i) holding meetings of managers or members or carrying on any other activities concerning the LLC's internal affairs;⁹ (ii) maintaining bank accounts;¹⁰ or (iii) securing or collecting debts or enforcing mortgages.¹¹

California law makes it clear that foreign limited liability companies are not transacting intrastate business in California solely because they are members of California limited liability companies, nor are foreign limited liability companies transacting intrastate business in California because their managers or members live in California or conduct meetings in California. The FTB would have to show that the manager or the managing member actively transacts the LLC's business within California.

Even if a foreign limited liability company is not required to register with the State of California it may still be subject to the California franchise tax if the LLC is doing business in California.¹² "Doing business" has been defined as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."¹³

The California State Board of Equalization has ruled that passive ownership of an interest in a California legal entity does not rise to the level of "actively" engaging in a transaction.¹⁴ The SBE based its decision on the fact that a limited partner in a limited partnership cannot, based on the relevant provisions of partnership law and the limited partnership agreement, participate in the active management of the partnership. Only the general partner may do so. The SBE's logic is equally applicable to members of a limited liability company who are not managers and who by the provisions of the operating agreement are precluded from participating in the active management of the LLC.¹⁵

It should be noted that a corporation that is a holding company (organized for the purpose of holding interests in other legal entities) is not deemed to be doing business in California.¹⁶ The same provision was not included by the legislature in the LLC franchise tax statutes, but one can draw an inference that LLCs that are solely holding companies are not doing business in California.

IV. CONCLUSION

The FTB's mission statement directs the agency to fairly represent the state and the taxpayers, not to aggressively

collect revenue beyond its reach. The FTB needs to re-orient its aggressive stance on foreign LLC registration requirements and consistent with California statutes and Constitutional restraints.

ENDNOTES

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2. The dormant Commerce Clause, sometimes called the negative Commerce Clause, refers to the power Congress can exercise over interstate commerce but has not yet exercised.
3. *Quill v. North Dakota*, 504 U.S. 298, 119 L. Ed. 2d 91 (1992); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 777, 112 S. Ct. 2251 (1992).
4. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 51 L. Ed. 2d 326 (1977).
5. *Wisconsin v. J.C. Penney*, 311 U.S. 435, 444, 61 S. Ct. 246 (1940).
6. Cal. Corp. Code §17451(a).
7. Cal. Corp. Code §17001(ap).
8. Cal. Corp. Code §17001(ap)(1)(F), 17001(ap)(3). "A person shall not be deemed to be transacting intrastate business in this state merely because of its status as a member or manager of a domestic limited liability company or a foreign limited liability company registered to transact intrastate business in this state."
9. Cal. Corp. Code §17001(ap)(2)(B).
10. Cal. Corp. Code §17001(ap)(2)(C).
11. Cal. Corp. Code §17001(ap)(2)(H).
12. Cal. Rev. and Tax. Code §17941(a).
13. Cal. Rev. and Tax. Code §23101.
14. *In re Appeals of Amman & Schmid Finanz AG et. al.*, No. 96-SBE-008, 1996 WL 281551 (1996).
15. N.B. The FTB Publication 3556 provides that a foreign LLC that is a member of a California LLC will be deemed to be doing business in California. There is no explanation for this statement and it appears to be entirely at odds with the California statutes and the SBE decision in *Amman*.
16. Cal. Rev. and Tax. Code §23102.