

California – LLC fee regulation provides guidance on flow-through income

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In brief

On May 14, 2014, California adopted regulation 17942, which provides guidance regarding an LLC's total income from all sources derived from or attributable to California. The regulation provides guidance on: (1) the treatment of flow-through income from partnerships, (2) special assignment rules for total income from certain passive holdings and occasional sales, (3) an alternative method for assigning total income, and (4) disregarding the assignment rules if all business activities are conducted in California.

In detail

California's LLC fee is imposed on LLCs organized, registered to do business, or doing business in California. The fee is measured by an LLC's "total income from all sources derived from or attributable to [California] for the taxable year," which includes total gross income plus cost of goods sold.

Applicable to taxable years beginning on or after January 1, 2012, California regulation 17942 provides guidance regarding the attribution of flow-through income received by LLCs that conduct business both within and without California.

Assignment rules – same as California's corporation income tax

Pursuant to the regulation, LLCs generally use California corporation income tax sales factor assignment rules to compute California sourced income for LLC fee purposes.

For tax years beginning on or after January 1, 2012, sales other than sales of tangible personal property are sourced using the same methodology the LLC used for California income tax purposes. For the 2012 tax year, this means costs of performance or market-based if the LLC so elected. For the 2013 and subsequent tax years, this means a market-based approach.

Special assignment rules

Special assignment rules are provided for items of income that are not subject to apportionment for California income tax purposes:

- Income from the passive holding of intangible personal property is sourced to the location from which the intangible property is managed.
- Occasional sales are sourced, rather than excluded if substantial and occasional, using the same methodology the LLC used for California income tax purposes. For sales of non-tangible property, this means costs of performance or market-based if the LLC so elected for the 2012 tax year. For the

2013 and subsequent tax years, this means a market-based approach on sales of non-tangible property.

Alternative method of assigning total income

As an alternative, multistate LLCs may utilize the following apportionment information:

- An LLC with its own California sales factor numerator over \$5 million does not have to calculate additional California distributive share sourced income amounts because the sales factor amount exceeds the LLC fee's highest bracket.
- An LLC with its own California sales factor numerator under \$5 million may use its numerator as a starting point and make the following adjustments:
 - assign all items of total income from all sources that were previously assigned as nonbusiness income for apportionment purposes, using the assignment rules for business income
 - assign all items of total income from all sources that

were excluded from the sales factor numerator pursuant to California's exclusion provisions

- remove all items of total income that were derived from or attributable to other LLCs that were subject to the LLC fee.

Distributions of income 'subject to' the fee are excluded

California law provides that an LLC's California attributed income does not include distributions from another LLC to the extent that such income is 'subject to' the LLC fee.

Regulation 17942 provides an example regarding Parent LLC's distributive share of income composed of California sourced income received from Subsidiary LLC. Subsidiary LLC does not pay California's LLC fee because its total California sourced income is below the \$250,000 minimum threshold for imposition of the fee. Even though Subsidiary LLC does not actually pay the LLC fee, its California sourced income is 'subject to' the fee, and therefore any such total income that flows up to Parent LLC is not included in Parent LLC's income for purposes of the LLC fee.

Assignment of pass-through entity income

An LLC's distributive share of California sourced income from other pass-through entities is assigned to the state where the partnership assigned the income on the Schedule K-1 provided to the LLC.

The takeaway

Although the LLC fee is capped at \$11,790 per entity, the potential exposure can multiply dramatically for sophisticated legal structures with multiple LLCs. For those impacted organizations, Regulation 17942 may be a concern for several reasons, including:

- The rules are specific to the LLC fee. The risk exists that a taxpayer could arrive at sourcing conclusions for the LLC fee that differ from sourcing for corporate income and franchise tax purposes.
- The regulation examples describe transactions with very simple taxpayer structures. The regulation leaves open many questions and creates considerable challenges for how these rules may practically apply to complicated organizations.

Let's talk

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