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Arizona suing California over the FTB's doing business interpretation

The case challenges the FTB's aggressive position, which imposes $800 annual/minimum taxes against out-of-state entities.

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Editor

In the latest battle over the FTB's position on taxpayers "doing business" in California, Arizona is suing California, alleging that California is imposing an unconstitutional tax against Arizona businesses and individuals that don't actually conduct any business in California.[1] The case was brought directly to the U.S. Supreme Court because it is the only court that hears cases in which a state sues another state.

In their suit, Arizona points out that both a California court of appeal and the Office of Tax Appeals (OTA) have ruled against the FTB and their doing business arguments in the *Swart* [2] and *Satview Broadband* [3] cases. However, the FTB has not backed down from its position taken in Legal Ruling 2014-01.

The FTB's doing business argument

Legal Ruling 2014-01 states that LLCs taxed as partnerships are essentially general partnerships. As a result, if an LLC taxed as a partnership is doing business in California, all of the members of that LLC are also doing business in California, even if they are minority members with strict restrictive member agreements. If any of those members are another LLC, or a corporation, they are required to file a California return and pay an $800 annual or minimum tax.

Last year, the FTB issued Legal Ruling 2018-01 in light of the *Swart* decision and stated that a narrow exception applies if the taxpayer has a fact pattern similar to the taxpayers in *Swart*. In *Swart*, a California court of appeal held that an out-of-state corporation with a 0.2% interest in a California manager-managed LLC was not doing business in California as a result of its passive investment in the LLC.

FTB Legal Ruling 2018-01 alludes to the fact that a member could own more than 0.2% and not be subject to the $800 annual/minimum tax, but it does not say how much more. In previous statements released by the FTB, they noted that only members with a 0.2% interest or less would qualify for relief under *Swart*. And the Arizona case points to the fact that the FTB's form letter denying refund claims from Arizona taxpayers references the 0.2% ownership as a critical fact.

Note: Spidell also disagrees with the FTB's narrow interpretation of the *Swart* decision.

Arizona's argument

Arizona's complaint alleges that California is not content to assess tax solely against entities actually conducting business in California. Instead, they argue that California applies its doing business definition so expansively that it reaches out-of-state companies that do not conduct any actual business in California, and have no connection to the state except for purely passive investment in California companies. For example, California has made assessments against several Arizona-based companies that have no connection to California whatsoever except purely passive investment in an LLC doing business in California.

The argument alleges that *South Dakota v. Wayfair*,[4] and *Shaffer v. Heitner*,[5] make plain that passive investment in an out-of-state company does not satisfy the "minimum contacts" standard. The argument also states that California's actions violate all four independent Commerce Clause requirements for out-of-state taxation under *Complete Auto Transit, Inc. v. Brady*.[6]

Collection activity also an issue

In addition to challenging the constitutionality of the FTB's doing business position, the Arizona case alleges that the FTB's collection activity violates both the Due Process Clause and the Fourth Amendment.

The Arizona attorney general's press release on the case states: "Making matters worse, if California's tax assessments are not paid voluntarily, California frequently further tramples on the sovereignty of other states by issuing orders to interstate banks, demanding that they transfer funds in Arizona-based accounts for back payment. Those seizure orders threaten the banks that, if they do not transfer the funds, California will take the taxes and penalties owed from the banks instead. Not surprisingly, the banks almost uniformly consent to California's strong-arm tactics."

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[1] *State of Arizona v. State of California*, filed with the U.S. Supreme Court

[2] *Swart Enterprises, Inc. v. FTB* (2017) 7 Cal.App.5th 497

[3] *Appeal of Satview Broadband, LTD* (September 25, 2018) 2018-OTA-121

[4] *South Dakota v. Wayfair, Inc.* (2018) 138 S.Ct. 2080

[5] *Shaffer v. Heitner* (1977) 433 U.S. 186

[6] *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274

About the Author

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