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How California Taxes the Sale of LLC Interests by Nonresidents

by
Christopher Manes

California residents who plan to move to another (by definition lower income tax) state, either to retire or for business purposes, often face the problem of how to handle their business interests situated in California. Mostly these interests are LLCs, the preferred entity for most modern business operations. The taxpayer often wants to hold onto the LLC interests and continue to get the income stream until some later date after the move. The question that arises is, what are the California income tax consequences of selling a California LLC interest after the taxpayer changes residency to another state?

I'm assuming the business owner has already weighed the risk of retaining his California business interests while disentangling himself from California by reducing his contacts here and establishing residency elsewhere. Obviously any continued contacts with California are red flags for California's taxing authority, the Franchise Tax Board, which determines residency in part through a "contacts test," evaluating which state the taxpayer has the most contacts with. Business interests are just the type of substantial contact that can weigh heavily in determining residency, and can trigger a costly residency audit. In addition, unless the circumstances are very unusual, the income allocated from the LLC to the taxpayer will be California source even after the taxpayer leaves the state. That means the former Californian will have to file nonresident tax returns with Sacramento (the Form 540NR), and the FTB will know about his global income. If the income is high, it again sends up a red flag that could lead to a residency audit.

But assuming that this decision has already been made, and the taxpayer decided to keep his California business interests despite the risks of an audit, the next issue is planning for the eventual sale of the interest as an out-of-state resident.

On its face, the rule is relatively simple. California generally taxes all income that has its source within the state. The fact that the taxpayer moved to another state doesn't alter that result. With businesses, the state they operate in is called their "situs." It follows that an LLC set up, located and operating in California has a California business situs, and its income is California source. But California LLC interests have special business situs rules when it comes to sales. Income for the sale of intangible interests (stocks, bonds, notes, and LLCs) is not considered derived from California sources unless the intangible property itself has a business situs here. Clearly LLCs that operate in California have a situs here for purpose of their income taxes. But the ownership interest itself takes on the residence status of the owner. Thus, an LLC interest owned by a nonresident is generally deemed a "non-California situs intangible interest" even if the business is set up, located and operates in California. So while the income from LLC operations in California paid to the nonresident is usually California source and is subject to California income taxes, the income from the sale of the LLC interest itself is not.

Unfortunately this rule gets more complex in practice.

Business owners often have more than just a passive relationship to LLCs they have equity in. Often they not only invest in the LLC, but use their interest to leverage other investments. And that often involves pledging the LLC interest as collateral for loans. And in many cases, a control group of investors own related LLCs, and the loans are used to keep the related operations afloat or pay their debts. This can lead to the nonresident unwittingly creating a business situs for his intangible ownership interest in a California LLC, which otherwise could be sold free of California taxation.

The regulations give the classic example of a nonresident who pledges intangible personal property in California as security to pay indebtedness or taxes related to a California business. This is the LLC owner who takes out a loan to pay the debts or otherwise capitalize a related LLC, and the LLC interest is pledged as collateral. In that case, the intangible property acquires a business situs in California. It is no longer "non-California situs intangible property." When the interest is sold, California can tax the gain, even though the owner is a nonresident.

Nonresidents can also get into trouble if they buy and sell LLC interests in California (or place orders with brokers in this state to buy or sell such intangible property) so regularly, systematically, and continuously as to constitute doing business in California. In that case the sales themselves are deemed California source.

So while the rule seems simple when it comes to nonresidents selling their California LLC interests, they need to realize that the application often requires considerable analysis.

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