California FTB Answers the Question: Does an "LP Nothing" Really Matter?

12.02.2019 | By Douglas W. Schwartz

Anyone could see that, for a limited partnership ("**LP**") that was a "tax nothing" – *i.e.,* one "**disregarded**" for federal income tax purposes – the corresponding California treatment was very confusing. To clear up this confusion, on November 20th the California Franchise Tax Board ("**FTB**") issued guidance (Legal Ruling 2019-02) concluding that an LP that is disregarded for federal income tax purposes is also disregarded for California franchise tax purposes – in fact, a disregarded LP need not file a California tax return nor pay the annual $800 California franchise tax. The FTB also issued companion guidance (Notice 2019-06) on how a disregarded LP should alert the FTB to obtain that treatment and seek refunds for prior franchise tax payments. This twin FTB guidance presents favorable planning opportunities (particularly for taxpayers holding multiple California properties) and a limited window for obtaining refunds.

Background

Under the U.S. Treasury's "check-the-box" regulations (Treas. Reg. § 301.7701-3), a domestic non-corporation business entity with only one U.S. owner is "disregarded" for income tax purposes unless the owner files an election with the IRS to treat the entity as a corporation for tax purposes. The owner reports the income and assets of a disregarded entity on the owner's tax return. The garden-variety disregarded entity is a limited liability company ("**LLC**") with a single owner. However, an LP can also be disregarded. For example, if "Freddie" (who can be an individual, trust, corporation, or other entity) were to form a wholly-owned LLC and then form an LP with the LLC as the general partner and Freddie as the sole limited partner, then the LP is disregarded because the LLC is disregarded and not treated as an entity separate from Freddie. (See IRS Revenue Ruling 2004-77 and Private Letter Ruling 200807005.) Yet, so long as Freddie is careful to document the entity and follow the rules for maintaining the general partner LLC's status as an economically-viable entity and Freddie's status as a "true" limited partner (more on that below), the LP is a perfectly valid entity for business purposes with only the LLC general partner exposed for the LP's liabilities. If the LP were to acquire a second limited partner in addition to Freddie, it would stay an LP for state

business law purposes but transform from a “tax nothing” to a “partnership” for federal income tax purposes.

There could be many reasons that Freddie would want to form the entity as an LP rather than an LLC, even though Freddie retains 100% effective ownership: State licensing or other laws may not allow Freddie to conduct a certain business through an LLC (but allow it for an LP); the state might tax LLCs more heavily than it does LPs; the state’s business laws may allow greater protection from creditors if an LP is used; a bank or other lender might prefer an LP; and an LP might offer family wealth planning advantages relative to an LLC if Freddie wishes to pass interests on to other generations. An LLC does present advantages because the paperwork is less: Only one set of articles needs to be filed and one operating agreement prepared, whereas an LP requires one set of documents for the LLC general partner and another set between that LLC and the owner. Plus, under the California Revised Uniform Limited Liability Company Act (“**RULLCA**”), no member in an LLC is personally liable for the LLC’s debts (subject to limited exceptions). However, under the California Uniform Limited Partnership Act (“**ULPA**”), there must be at least one adequately-capitalized general partner with personal liability for the LP’s debts (and a limited partner like Freddie may also become liable if Freddie is actively involved in the LP’s management, as opposed to derivatively as manager or officer of the LLC general partner).

California Revenue & Taxation Code (“**R&TC**”) section 23038(b)(2)(B)(iii) provides that any entity that is “disregarded” for federal income tax purposes must also be “disregarded” for California franchise tax purposes (and, therefore, the owner cannot elect different treatment in order to take advantage of federal versus California tax benefits). However, there are exceptions in four specific instances for an LLC: (1) the LLC must pay the annual $800 California franchise tax; (2) it must pay the annual California fee (up to $11,790) based on gross receipts; (3) it must file a California Form 568 return; and (4) it must separately determine California tax credits.

For many years, taxpayers and their advisors (and the FTB!) were unsure about how to treat LPs that were disregarded. To be safe, LP taxpayers filed a California Form 565 partnership return and paid the annual $800 franchise tax. Those that didn’t could be sure of receiving a notice from the FTB that a return and the franchise tax were due and delinquent.

Import of the FTB’s recent guidance

In Legal Ruling 2019-02, the FTB concluded that, because R&TC section 23038 did not make exceptions for disregarded LPs – just disregarded LLCs – a disregarded LP need not file a return nor pay an annual franchise tax. Notice 2019-06 goes on to describe how an LP (including one that has received an FTB demand for past returns) notifies the FTB (by fax, mail, or courier as set forth in the Notice) that it is disregarded:

- A disregarded LP should submit either of the following sets of documentation to the FTB: **(i)** certificate of limited partnership, partnership agreement, ownership organizational chart, and partners' federal returns for the tax year(s) in question; or **(ii)** a signed declaration (under penalty of perjury by the LP’s general partner) stating that the entity was disregarded for federal income tax purposes during the respective tax years.
- Currently, there are appeals before the California Office of Tax Appeals on the issue of whether disregarded LPs are subject to a filing requirement and the minimum franchise tax of $800. While Legal Ruling 2019-02 will help resolve many of these appeals, affected taxpayers (particularly those with tiered disregarded partnership structures, such as real property or management companies) should comply with the Office of Tax Appeals’ procedural rules in addition to Notice 2019-06.

In Notice 2019-06, the FTB also describes how a disregarded LP may seek a refund of prior payments of franchise taxes (which, according to Legal Ruling 2019-02, were never required). Although the franchise tax is “only” $800 per year per LP, those taxes can add up over multiple years and for multiple LPs. Be advised that Notice 2019-06 *does not* mitigate or otherwise address the statute of limitations for filing a refund claim (which, generally, is four years after the Form 565 return is filed, or one year after the tax is paid, whichever period expires later).

Planning after the FTB guidance

As can be seen from the above, Legal Ruling 2019-02 and Notice 2019-06 are taxpayer friendly and present many tax planning opportunities:

- Though choosing between an LLC and LP is a balancing act, the recent FTB guidance may tip the scales in favor of using LPs because there is now no separate return filing or franchise tax payment requirement. Plus, using LPs has always tended to reduce the impact of the LLC gross receipts fee (which can add up where, for example, the taxpayer owns multiple real properties in California through separate LLCs).
- Taxpayers with existing LLCs may wish to consider converting them to LPs. The RULLCA and ULPA provide for a direct conversion from an LLC to an LP by filing Form LP-1A (Certificate of Limited Partnership – Conversion) with the California Secretary of State. Again, taxpayers need to balance the professional and other fees and the risks of an LP against the projected tax savings. Taxpayers should also check covenants and restrictions in loan documents, leases, or other agreements, because a conversion may be allowed only with notice to and/or consent by the counterparty (if at all).
- LPs must pay heed to the statute of limitations for filing a refund claim, and file those claims sooner rather than later.
- Remember that the California legislature can always amend R&TC section 23038 to provide that disregarded LPs must file returns and pay the franchise tax. (Texas, for example, applies its franchise tax to LLCs and LPs in the same manner.) Therefore, there may be a limited window for taking advantage of the planning opportunities from the FTB guidance (just as there is a limited window for filing for refunds).
- Also remember that any “disregarded” LLC serving as the LP’s general partner still has return filing and tax payment obligations under R&TC section 23038. The recent FTB guidance does not change those requirements.

How we can help

We are experienced in advising clients on the best structure, from a tax and business viewpoint, for holding real estate and operating businesses, and in forming and documenting such entities. We can also assist in preparing and filing appropriate claims for tax refunds. Please contact us if you would like further information or assistance regarding these matters.