Investing in California Real Property — Tax and Withholding

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In this viewpoint, the authors discuss federal and California taxation of nonresident individuals who invest in California real estate using a passthrough entity.

With a GDP of $2.5 trillion, California can claim to be the world's sixth largest economy — just behind the U.K. but ahead of France. As you might expect, the Golden State offers nonresidents an embarrassment of investment opportunities. California's business has become everybody's business.

Silicon Valley likes to think that it is inventing the future. Hollywood prides itself on entertaining the world. California real estate is low-tech and inescapably local, but it is certainly no slouch. Real estate values have gone from merely sky-high to stratospheric. That's the kind of trend that attracts investors from around the country and, these days, from around the world.

But profitable investment means taxes, so nonresidents need to understand what they are getting into when they invest in California real estate. We will focus on nonresident individuals who invest through a passthrough entity classified as a partnership for federal and California income tax purposes.[1]

Taking a global perspective, we will begin with the federal treatment of nonresidents — that is, nonresident aliens (NRAs) — who invest in California real property. With the federal rules as a baseline for comparison, we will then examine how California taxes nonresident individuals. Inclusive California generally taxes nonresidents in the same way, whether they live in Bangor or Bangalore. But there are exceptions, as we will see when we look at California's withholding rules.

For purposes of discussion, we will focus on Real Property LLC (Propco), a hypothetical limited liability company that owns and operates income-producing real property in California. We will assume that Propco is a domestic entity taxed as a partnership. If Propco is not organized in California, we assume it is registered to do business there.

Investors want income and especially gain, and yet they may not think about taxes except as an afterthought. Of course, someone must understand how the United States and California will tax the nonresident individuals who are members of Propco. And when we talk about taxes, we also must talk about potential withholding liability.

We will first consider how the two tax systems deal with Propco's current income from operations (including its sales of real property). Then, we will

[1] California conforms to the federal definition of partnership.

look at how the two systems treat a nonresident who sells his membership interest. Gain on sale is usually the big payday that investors want.

Federal Taxation of Income From LLC Operations

How does the United States tax NRA members on Propco's income from current operations? It generally depends on the type of income earned by the LLC.

Effectively Connected Income

IRC section 871(b) taxes an NRA on income that is effectively connected with a U.S. trade or business (effectively connected income, or ECI) conducted by that individual. If the NRA is a member of an LLC or other entity taxed as a partnership, he is also treated as conducting any trade or business conducted by the entity.[2]

Suppose that Propco's real estate activities in California are so substantial, regular, and continuous that they constitute a trade or business. Most people would not expect this, and many people would try to avoid it. If it occurs, the nonresident's share of the LLC's operating income (net of deductions permitted under IRC section 873) is ECI.

Under section 871(b), the nonresident member must pay tax on this ECI at the same graduated rates applicable to U.S. residents. The NRA may also be subject to the alternative minimum tax under IRC section 55.

FDAP Income

What if Propco, instead of engaging in an active business, owns only a single building, which it rents out under a triple-net lease to a single tenant? Such activities probably do not amount to a U.S. trade or business.[3] In that case, the rent paid to Propco is not taxable to the nonresident member as ECI.

However, the rent is still U.S.-source income under IRC section 861(a)(4). As a result, the LLC and its members do not get off tax free. The rent is classified as fixed or determinable annual or periodic gains, profits, and income (FDAP) under IRC section 871(a)(1)(A). Unless a treaty provides otherwise, IRC section 871(a) taxes the nonresident member's share of FDAP at a flat 30 percent.

Under section 871(d), an NRA can make a net basis election to treat his share of rental income as ECI. If he makes the election, he is taxed under IRC section 871(b). That means he can deduct his share of the LLC's depreciation, real estate taxes, and other related expenses. That is typically a big improvement over gross basis taxation of rent as FDAP.

Gain From U.S. Real Property Interests

Suppose that Propco decides to sell some of its California real property. Historically, the United States has not taxed NRAs on their capital gains. However, gain from the sale of a U.S. real property interest (USRPI) has been subject to U.S. tax since the 1980 Foreign Investment in Real Property Tax Act added section 897 to the code.

If a nonresident sells a USRPI, IRC section 897(a)(1) treats his gain as ECI, which triggers tax under section 871(b). If Propco sells some of its California real property, section 897(a)(1) will apply to the gain that passes through to a member who is an NRA.

Collecting Federal Tax — Withholding Rules Rule!

Imposing a tax is one thing — collecting it is another. NRAs pose a serious enforcement challenge because they and the bulk of their assets are typically beyond the reach of the IRS's collection efforts. As Lord Mansfield famously observed, "no country ever takes notice of the revenue laws of another."[4]

Almost 250 years later, refusing to enforce another nation's tax laws (the "revenue rule") is still the international norm. In the absence of enforcement mechanisms, it would be risky — to put it mildly — to assume that NRAs will file returns with the IRS and pay their U.S. tax. The IRC's realistic response is to impose tax withholding obligations on persons making payments to NRAs.

[2]IRC section 875(1).

[3]*Neill v. Commissioner*, 46 B.T.A. 197 (1942).

[4]*Holman v. Johnson*, 98 Eng. Rep. 1120 (K.B. 1775).

IRC section 1441(a) reflects this risk-reduction strategy. Anyone paying FDAP to an NRA or a foreign partnership must deduct and remit a 30 percent withholding tax. This satisfies the 30 percent tax imposed on the payee by section 871(a). The U.S. does not even ask the nonresident to file a tax return.[5]

Withholding does not apply to FDAP paid to Propco, because we have assumed that it is a domestic entity. But section 1441(b) treats the nonresident members as if they were being paid their share of the LLC's FDAP. This imposes a withholding obligation on the LLC, which must pay the 30 percent tax even if it makes no actual distributions to the nonresidents.[6]

ECI paid to an NRA directly conducting a U.S. trade of business is treated differently from FDAP. Under IRC section 1441(c)(1), withholding does not apply to income other than compensation for services. Why the relaxed approach? Perhaps an NRA carrying on a full-fledged trade or business in the United States has an adequate incentive to comply with U.S. tax law. The U.S. business also provides the IRS with a collection target if the NRA does not comply. In any event, imposing withholding responsibilities on everyone who makes a payment to an operating trade or business seems impractical.

But everything changes if the NRA earns the ECI through Propco. Section 1446(a) requires the LLC to remit tax on the nonresident's share of ECI, regardless of whether it is distributed. The LLC must withhold at the highest individual rate, taking account of the character of the income.[7]

Requiring Propco to withhold seems sensible. First, the IRS cannot collect a member's unpaid tax directly from the U.S. business assets, because they belong to the LLC. Second, imposing a quarterly withholding obligation on a single agent (the entity) massively reduces the administrative cost of compliance. It would be surprising if section 1446 did *not* withhold on this low-hanging fruit.

If Propco sells some of its California real property, it can certify that it is a domestic entity. In that way, the buyer will not have to withhold 15 percent of the sale proceeds under IRC section 1445(a). However, section 897(a)(1) treats gain from the sale of a USRPI as ECI. So Propco will have to withhold on an NRA's share of the gain in accordance with IRC section 1446.

California Taxation of LLC Operations

With this federal tax law overlay, let's turn back to California and its treatment of nonresidents. Unlike the IRC, California's substantive tax law does not distinguish between NRAs and domestic nonresident individuals. Nonresidents, of whatever stripe, are simply taxed on their income from California sources.[8]

California-source income of a nonresident member of Propco consists of that member's share of income derived from sources in California.[9] Income that Propco derives from its California real property is sourced to California and imputed to its members. This includes any gain that Propco realizes by selling its real property.[10] In addition, Propco's income attributable to a trade or business in California (if it has one) is taxable to its members as California-source income.[11]

Collecting California Tax — Elective Withholding?

Withholding is the alpha and omega of the federal system. If an NRA derives FDAP or ECI from an entity classified as a partnership, *some* form of withholding is pretty much mandatory. If the income is ECI, the NRA must still file a U.S. tax return. But the tax will already have been collected (and possibly overcollected) at source, not unlike tax on FDAP.

When it comes to NRAs who are members of an LLC taxed as a partnership (foreign members), California actually follows the feds. California conforms to IRC section 1446 regarding income effectively connected with a California trade or business. Under Revenue and Taxation Code (RTC) section 18666(a), foreign members are subject to withholding at 12.3 percent.

[5] Reg. section 1.6012-1(b)(2)(i).

[6] Reg. section 1.1441-5(b)(2)(i)(A).

[7] Reg. section 1.1446-3(a)(2)(ii).

[8] Cal. Rev. and Tax. Code section 17951(a).

[9] Cal. Reg. section 17951-1(b).

[10] Cal. Reg. section 17951-3.

[11] Cal. Reg. section 17951-4(a).

However, California goes its own way when it comes to nonresidents who are U.S. persons (domestic nonresident members, or DNMs). Withholding plays a role, but it ultimately functions as a backup. What California appears to want is for domestic nonresident members to opt in to the California tax system, filing returns and paying their taxes like anybody else. Withholding — or rather the threat of withholding — appears to be one tool to help make that happen.

This is clearly illustrated by RTC section 18633.5(e). An LLC doing business in California is required to obtain the agreement of each of its nonresident members:

> to file a return . . . to make timely payment of all taxes imposed on the member by this state with respect to the income of the limited liability company, and to be subject to the personal jurisdiction of this state for purposes of the collection of income taxes.

If a DNM will not agree to these terms, the LLC must withhold on his share of California-source income at the same 12.3 percent rate imposed on foreign members.

Withholding under IRC section 18633.5(e) can be a serious matter. In practical terms, however, it is elective. If a DNM promises to behave like a California resident and submits to the personal jurisdiction of the California courts, the statutory withholding vanishes. That is not an option for nonresidents at the federal level. Operating in the shadow of the revenue rule, the IRC requires a domestic LLC to withhold on an NRA no matter what.

The state-level version of the revenue rule will sometimes prevent California from suing a nonresident in another state to establish his tax liability. However, the full faith and credit clause of the Constitution requires other states to enforce a California judgment against the nonresident for unpaid taxes.[12] This is why RTC section 18633.5(e) requires nonresident members to consent to the personal jurisdiction of the California courts. It is interesting to note that Form 3832, which a DNM must sign to evidence his consent, does not track the statute. Instead, it asks for "consent to the jurisdiction of the State of California to tax my distributive share of the LLC income attributable to California sources."

Does consenting to California's jurisdiction to tax imply consent to the personal jurisdiction of the California courts? Probably, but the Franchise Tax Board may want to update Form 3832 to make the point explicit. Courts have recently been questioning implied consent to personal jurisdiction in other contexts. For example, the Second Circuit recently considered a corporation registered to do business in Connecticut that had appointed an agent for service of process there.[13] Those facts alone, however, did not mean that the corporation had consented to the general jurisdiction of the state's courts.

7 Percent Solution?

Even if a DNM agrees to play ball in California, he has yet another hoop to jump through. RTC section 18662 imposes a second withholding tax (at 7 percent) on a variety of payments to domestic nonresidents. This includes distributions of California-source income to nonresident members of an LLC.

Getting hit with California state tax withholding on distributions may be quite galling to a DNM, particularly one who has been keeping his promise to report and pay tax on his share of the LLC's California-source income. But withholding under RTC section 18662 turns out to be largely elective as well.

The DNM has no shortage of options. The simplest is to fill out Form 590-P, "Nonresident Withholding Exemption Certificate for Previously Reported Income," and give it to the withholding agent. Nothing is filed with the FTB. Form 590-P certifies that the DNM has already reported and paid tax on his share of California-source income in a prior year and that he is current on filing any required California returns. This lets the LLC distribute the prior year's California-source income free of withholding.

[12] *Milwaukee County v. M.E. White Co.*, 296 U.S. 268 (1935).

[13] *Brown v. Lockheed Martin Corp.*, Civ. No. 14-4083, 2016 WL 641392 (2d Cir. Feb. 18, 2016).

A second option is for the nonresident member to file Form 588 with the FTB requesting a waiver of withholding based on his exemplary compliance history. The DNM must have California tax returns on file for the two most recent years in which he had a filing requirement. He must also be current on any California tax obligations.

Most nonresidents should be able to handle Form 588. It is non-threatening and is only two pages long. But what if a DNM is a recent investor and has not yet filed two years of California returns? No problem. If the DNM is making estimated tax payments, a waiver is still available. The only catch is that it will be limited to the current calendar year, so the DNM will need to file another form the next year.

A third option is to file Form 589 to request a reduced rate of withholding because the nonresident has deductible expenses that will predictably reduce his California tax liability. This avenue of relief is open to both domestic and foreign nonresident members.

In the latter case, the non-U.S. member must first seek parallel relief from the IRS by filing federal Form 8804-C, "Certificate of Partner-Level Items to Reduce Section 1446 Withholding." The process is a bit paper intensive. However, it can be worth the effort if the dollars are significant.

Finally, the DNM can elect to participate in a composite return under RTC section 18535. The LLC prepares the return and pays the tax on behalf of the participating nonresident members. This minimizes compliance hassles. A participant can then file Form 588 to get a waiver of withholding on distributions from the LLC.

Composite returns are convenient, but they come at a price. Tax is imposed at the highest individual rate (12.3 percent, but hiked to 13.3 percent if the DNM has California-source income of $1 million or more). No deductions or credits are allowed except those directly attributable to the LLC's activities.

Given the number and tenor of these exceptions, it seems fair to say that California's withholding rules play only a secondary role in collecting tax from DNMs. The threat of 12.3 percent withholding under RTC section 18633.5(e) is a stick to get domestic nonresidents to opt into the California tax system. Once they have done so, withholding on distributions functions as little more than a backup, just in case they break their promise to file and pay tax in California.

Taxing Sales of LLC Interests

Let's move up to the member level. How do the IRC and California law treat a nonresident who sells his membership interest in Propco?

Federal: LLC Interests as USRPIs

FIRPTA treats an NRA's share of gain from the LLC's sale of a USRPI as ECI taxable under IRC section 871(b). The USRPI definition has two legs. The first covers any interest in real property located in the United States.[14] This includes fee ownership of real property, leasehold interests, life estates, reversions and other direct interests.[15]

The second leg of the definition treats stock of a domestic corporation as a USRPI if the corporation is or was a U.S. real property holding corporation (USRPHC) at any time during the five years preceding the sale.[16] A USRPHC is a corporation whose USRPIs have an aggregate fair market value that is at least 50 percent of its total value attributable to USRPIs, non-U.S. real property, and other assets used in its trade or business.

IRC section 897(g) leaves it to regulations to decide whether an interest in a partnership should be treated as a USRPI. Temp. reg. section 1.897-7T(a) takes up the gauntlet, declaring that a partnership interest is treated as a USRPI to the extent that the gain from the sale is attributable to the value of USRPIs held directly or indirectly by the partnership.

However, this look-through rule applies only if at least 50 percent of the value of the partnership's gross assets consists of USRPIs, and at least 90 percent of the value of its gross assets consists of USRPIs, cash, or cash equivalents. This "50-90 test" is an odd departure from the rule governing corporate stock. Suppose that a corporation's assets consist of USRPIs worth $60, non-U.S. real property worth $35, and $5 in cash.

[14]IRC section 897(c)(1)(A)(i).

[15]*See* reg. section 1.897-1(d)(2).

[16]IRC section 897(c)(1)(A)(ii).

The corporation is a USRPHC under section 897(c)(2), so its shares are USRPIs. But an interest in an LLC holding the same assets would *not* be a USRPI. Although USRPIs would represent 60 percent of the LLC's total value, the combined value of its USRPIs and cash would fall far short of the required 90 percent. The justification for this discontinuity seems unclear. Why should an NRA selling an interest in a real estate passthrough be treated more leniently than an NRA selling stock of an identical corporation?

The 50-90 test also determines whether the buyer of a partnership interest must withhold 15 percent of the purchase price in accordance with IRC section 1445(e)(5).[17] This is an all-or-nothing rule. If the 50-90 test is satisfied, all the sale proceeds are subject to withholding, even if USRPIs represent only a fraction of the LLC's total value.

California: LLC Interests as Intangibles

California taxes nonresidents on their gross income derived from California sources.[18] This includes gains from the sale of real property in California, regardless of where the sale is consummated, and "any other type of income derived from the ownership, control or management" of such real property.[19] Does this broad language extend to gain from the sale of an interest in an LLC that owns California real estate? The general answer is no.

RTC section 17952 says that a nonresident's income "from stocks, bonds, notes, or other intangible personal property" is not California-source income unless the property has acquired a business situs in California, or the nonresident buys or sells such property "so regularly, systematically, and continuously as to constitute doing business in this state."

The statutory list does not mention interests in passthrough entities. However, California joins a number of other states in characterizing partnership interests as intangible property.[20] The State Board of Equalization, California's administrative tax tribunal, has treated limited partnership interests as intangibles. Interests in LLCs are likely to be viewed in the same way. Hence, we should not expect gain from the sale of an interest in Propco to be treated as California-source income. The gain will be sourced to the member's domicile unless he is in the business of trading in such interests or his interest has acquired a business situs in California.

The business situs rule is worth a closer look. California reg. section 17952(c) states that intangible personal property has a business situs in California only if the intangible "is employed as capital" in California, or possession and control of the property has been localized in a trade or business in California to such a degree that "its substantial use and value [have] attach[ed] to and become an asset of" the in-state trade or business.

The classic example of employing intangible property as capital is using it as collateral to secure indebtedness that was incurred in a California business. For example, a lender to Propco might demand that the LLC mortgage its real property and require its members to pledge their interests. A nonresident who sells his interest is going to have California-source income.

Localization of an intangible is harder to pin down. California reg. section 17952(c) gives the example of a nonresident who maintains a branch office in California and a bank account on which the agent in charge of the branch may draw to pay branch expenses. The deposit account is an intangible, but its functional integration with the in-state business gives it a California situs.

The statute and regulations echo *Holly Sugar Corp. v. Johnson*.[21] In that seminal case, the California Supreme Court held that intangible property may acquire a tax situs other than the domicile of the owner "if it has become an integral part of some local business." Under both *Holly Sugar* and more recent BOE decisions involving partnerships, there must be some act by the nonresident owner to employ the value of the intangible in a California business.

[17] Temp. reg. section 1.1445-11T(d).

[18] Cal. Rev. and Tax. Code section 17951(a).

[19] Cal. reg. section 17951-3.

[20] *See Valentino v. Franchise Tax Board*, 87 Cal. App. 4th 1284, 1295 (2001).

[21] 18 Cal. 2d 218 (1941).

The FTB has had a good deal of trouble in accepting this. It periodically litigates the point, contending that simply conducting business in California through a passthrough entity meets the *Holly Sugar* standard. You are enjoying the fruits of California, the FTB seems to intimate, so pay up. The BOE has correctly rejected the FTB's arguments. Deriving value from owning an interest in an LLC conducting business in California should be OK. It is simply not the same thing as employing the value of an LLC interest to conduct a California business.[22]

Absent special facts involving business situs, a nonresident member who sells his interest in Propco should not be subject to California income tax on his gain. With no California tax, income tax withholding is irrelevant.

Real Estate Withholding Under California FIRPTA?

There is one more piece to the puzzle. In 1991 California adopted its own version of FIRPTA. Under RTC section 18662(e)(2), anyone purchasing a California real property interest (CRPI) from a domestic nonresident must withhold 3.33 percent of the sales price. The amount withheld is supposed to be an advance payment of the nonresident seller's income tax liability. The nonresident claims a credit for the withholding when he files his California return reporting his actual gain.

Does real estate withholding apply if a DNM sells his membership interest in Propco? As a general matter, withholding on the sale seems dubious, because California does not generally tax nonresidents when they sell an LLC interest (or other intangible). But a buyer worried about its potential liability as a withholding agent may want further assurances. After all, the buyer and its counsel will be expecting to withhold under FIRPTA if the membership interest is a USRPI under the 50-90 test. Shouldn't there be state-level withholding if the interest is a CRPI?

The nervous buyer has a point, but only if you assume that the nonresident's membership interest is in fact a CRPI. We need to look at the statute. RTC section 18662(e)(5) defines CRPI as property located in California and "defined in Section 897(c)(1)(A)(i) of the Internal Revenue Code." The code, in turn, refers to an "interest in real property (including a mine, well, or other deposits) located in the United States." So is an interest in Propco an "interest in real property" within the meaning of IRC section 897(c)(1)(A)(i)? The regulations discuss this term without ever mentioning passthrough entities.[23]

This would be a startling omission if section 897(c)(1)(A)(i) were supposed to cover an interest in a passthrough. Moreover, if an LLC interest *did* constitute an interest in real property described in section 897(c)(1)(A)(i), what would be the point of section 897(g) and temp. reg. section 1.897-7T(a)? Why lay out a rule for treating partnership (and LLC) interests as USRPIs if a partnership interest is *already* a USRPI under section 897(c)(1)(A)(i)?

The 50-90 rule would either be unnecessary or conflict with the statute. This is enough to show that an interest is Propco is not a CRPI within the meaning of RTC section 18662(e)(5). Consequently, real property withholding should not apply when a nonresident member sells his interest in Propco. This result makes policy sense, because California generally does not tax nonresident sales of LLC interests in the first place.

Conclusion

The U.S. corporate tax rate may be headed down, but LLCs, partnerships, and other passthroughs are likely here to stay. This means that investors will continue to wrestle not only with the IRC but also with a wide variety of state tax systems. And if federal tax rates go down, worry over high state taxes such as California's is likely to increase.

California is only one state, but it is an important one. Moreover, California's tax administration is notoriously aggressive. We hope that our quick overview has illustrated and perhaps illuminated some of the major approaches to taxing and withholding on nonresident individual members of an LLC. ■

[22] *See Appeal of Michael J. Bills*, SBE Docket No. 610028, 782397 (May 24, 2016); and *Appeal of Amyas and Evelyn P. Ames*, 87-SBE-042 (June 17, 1987).

[23] *See* Cal. reg. section 1.897-1(d)(2).