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Taxing Nonresident Investment in California Real Estate

By Donald P. Board • Wood LLP

Practicing tax law is not only about the Internal Revenue Code. Most domestic business activities and investments are subject to both the federal statute and at least one *state* income tax regime. For decades, a cadre of SALT specialists has been helping corporations coordinate their state and federal tax strategies.

However, the rise of passthrough entities as the preferred form for doing business has transformed the playing field. Cutting out the corporate middleman can certainly save taxes. But with that comfortable "blocker" removed, individuals investing in a passthrough can be thrust into direct contact with a wide range of state tax systems.

The states differ in what they tax and how they tax it. Sensible jurisdictions try to conform, more or less, to federal norms. But even the conformists take different positions on how their tax laws apply to nonresidents.

There are also major differences in the methods states use to *collect* the taxes they decide to impose. This is especially true when a nonresident is being taxed on income that he earned *indirectly*, as a member of a passthrough entity. Anyone advising passthroughs and their members about doing business or investing in other states will want to understand these methods and the best options for compliance.

Readers of *The M&A Tax Report* can relax—this article is not going to undertake one of those fifty-states-and-the-District-of-Columbia surveys. Comprehensive surveys can often be invaluable. But their densely populated charts assume that the user is *already* familiar with the major approaches to taxing nonresidents and collecting the taxes imposed.

This article takes a "case study" approach. It concentrates on a hypothetical LLC that owns real property in a single state—California. By narrowing our focus to federal and California law, we can expand the discussion to examine more of the "how's" and even some of "why's" of the two systems.

The goal is to provide a better sense of the big picture. And the big picture—plus one of those surveys—is what the practitioner needs when that client in Oregon calls about a passthrough opportunity in Kentucky.

LLC Investment in California Real Property

Assume that Real Estate LLC (Realco) is a limited liability company that owns and operates income-producing real property in California. Realco is a domestic entity taxed as a partnership. If it is not organized in California, it is registered to do business there.

We want to understand how the United States and California tax and withhold on *nonresident individuals* who are members of Realco. We will first consider how the two systems deal with Realco's current income from operations (including sales of real property). Then, we will look at how the two systems treat a nonresident who *sells* a membership interest in Realco.

Of course, the "nonresidents" the *federal* tax Code cares about are *nonresident aliens* (NRAs), not residents of Nevada or New York. The federal rules governing non-U.S. members are obviously becoming more important as real estate investing goes global. But the federal rules are also instructive because they illustrate several of the methods that states use to tax and to withhold on nonresidents who *are* U.S. persons.

California is a good state to consider because of its *differences* from the federal regime. On paper, California's withholding rules look almost as fearsome as their federal analogues. Yet, they turn out to play only a secondary role in collecting California tax on a domestic nonresident's share of operating income.

Another difference is California's treatment of nonresidents who sell their membership interests. At the federal level, we expect tax and withholding if the LLC is primarily a vehicle for owning and operating U.S. real estate. As we will see, however, laid-back California generally does not tax a nonresident's sale gain, even if it is directly attributable to the LLC's appreciated real estate in Sausalito.

It may also be worth noting that the Golden State's $2.5 trillion GDP (2015) makes it the *world's sixth largest economy*—just behind the United Kingdom but ahead of France. With California offering nonresidents a wealth of investment opportunities, out-of-state practitioners may want to get a better sense of the tax terrain.

Taxing LLC Operations: Federal

How are nonresident members taxed on Realco's income from current operations, including gains from its sales of California real property?

Effectively Connected Income

Axiomatically, Code Sec. 871(b) taxes an NRA on income that is effectively connected with a U.S. trade or business ("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*. [Code Sec. 875(1).]

Suppose that Realco's real estate activities in California are so substantial, regular, and continuous that they constitute a trade or business. The nonresident's share of the LLC's operating income (net of deductions permitted under Code Sec. 873) is ECI.

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Under Code Sec. 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 Code Sec. 55.

Taxing FDAP

What if Realco 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. [*E.M.L. Neill*, 46 BTA 197, Dec. 12,251 (1942).] In that case, the rent paid to Realco is not taxable to the nonresident member as ECI.

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

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

USRPI Gain

What if Realco 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 "United States real property interest" (USRPI) has been subject to U.S. tax since the Foreign Investment in Real Property Tax Act (FIRPTA) added Code Sec. 897 back in 1980.

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

Collecting Federal Tax—Withholding Rules Rule!

Imposing a tax is one thing—collecting it is another. NRAs pose a serious 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." [*Holman v. Johnson*, 98 Eng. Rep. 1120 (K.B. 1775).] Almost 250 years later, refusing to enforce another nation's tax laws (the so-called Revenue Rule) is still the international norm.

In the absence of enforcement mechanisms, we cannot assume that NRAs will file returns with the IRS and pay their U.S. tax. The Code's realistic response is to impose tax withholding obligations on persons making payments to NRAs.

Code Sec. 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 NRA by Code Sec. 871(a). The United States does not even ask the nonresident to file a tax return. [Reg. §1.6012-1(b)(2)(i).]

Withholding does not apply to FDAP paid to Realco because it is a domestic entity. But Code Sec. 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 over the 30-percent tax even if it makes no actual distributions. [Reg. §1.1441-5(b)(2)(i)(A).]

ECI paid to an NRA *directly* conducting a U.S. trade of business is treated very differently from FDAP. Under Code Sec. 1441(c)(1), withholding does not apply to income other than compensation of 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 target if the NRA does not comply. In any event, imposing withholding responsibilities on everybody who makes a payment to an operating trade or business seems impractical.

But everything changes if the NRA earns the ECI through Realco. Now, the LLC must remit tax on the NRA's share of ECI, whether distributed or not. [Code Sec. 1446(a).] The LLC must withhold at the highest individual rate, taking account of the character of the income. [Reg. §1.1446-3(a)(2)(ii).]

Requiring Realco 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 Code Sec. 1446 did *not* withhold on this low-hanging fruit.

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

Taxing LLC Operations: California

With this federal tax law overlay, let's turn back to California and its treatment of nonresidents. Unlike the Code, 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. [Revenue and Taxation Code ("R&TC") Sec. 17951(a).]

California-source income of a nonresident member of Realco includes his share of income derived from sources in California. [Reg. §17951-1(b).] Income that Realco derives from its California real property is sourced to California and imputed to its members.

This includes any gain that Realco realizes by selling its real property. [Reg. §17951-3.] In addition, Realco's income attributable to a trade or business in California (if it has one) is California-source income. [Reg. §17951-4(a).]

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 (or possibly over-collected) at source, just like 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 Code Sec. 1446 as regards income effectively connected with a California trade or business. Foreign members are subject to withholding at 12.3 percent. [R&TC Sec. 18666(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 back-up.

What California appears to want is for domestic nonresident members to opt into the California tax system, filing returns and paying their taxes like anybody else. Withholding—or rather the *threat* of withholding—is a way to make that happen.

This is clearly illustrated by R&TC Sec. 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 12.3 percent—the same rate applied to foreign members.

Withholding under R&TC Sec. 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 Code requires a domestic LLC to withhold on an NRA no matter what.

The *state*-level version of the Revenue Rule can 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. [*Milwaukee County v. M.E. White Co.*, SCt, 296 US 268 (1935).]

This is why RT&C 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 (FTB) may want to update Form 3832 to make the point explicit. Courts have recently been questioning implied consent to personal jurisdiction in other contexts. [*See, e.g.*, *Brown v. Lockheed Martin Corp.*, Civ. No. 14-4083, CA-2, 2016 WL 641392 (Feb. 18, 2016) (registering to do business in Connecticut and appointing an agent for service of process did *not* mean that corporation had consented to the general jurisdiction of the state's courts).]

Seven-percent Solution?

Even if a DNM agrees to play ball in California, he has yet another hoop to shoot for. R&TC Sec. 18662 imposes a *second* withholding tax (at seven 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 withholding on distributions would certainly be galling to a DNM who has been keeping his promise to report and pay tax on his share of the LLC's California-source income. But withholding under R&TC Sec. 18662 turns out to be largely elective as well.

The domestic nonresident member 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 (1) that the DNM has already reported and paid tax on his share of California-source income in a *prior* year, and (2) that he is current on filing any required returns. This lets the LLC distribute the prior year's California-source income free of withholding.

A second option is to file Form 588 with the FTB to request a waiver of withholding based on the nonresident's exemplary compliance history. The DNM must have California 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, which is all of 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 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, but it can be worth the effort if the dollars are significant.

Finally, the DNM can elect to participate in a composite return under R&TC Sec. 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 the 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 R&TC Sec. 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 back-up 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 Code and California law treat a nonresident who sells his membership interest in Realco?

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 Code Sec. 871(b). The definition of "United States real property interest" has two legs. The first covers any interest in real property located in the United States. [Code Sec. 897(c)(1)(A)(i).] This picks up fee ownership of real property, leasehold interests, life estates, reversions and other direct interests. [*See* Reg. §1.897-1(d)(2)).]

The second leg of the definition treats stock of a domestic corporation as a USRPI if the corporation is or was a "United States real property holding corporation" (USRPHC) at any time during the five years preceding the sale. [Code Sec. 897(c)(1)(A)(ii).] 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. [Code Sec. 897(c)(2).]

Code Sec. 897(g) leaves it to regulations to decide whether an interest in a *partnership* should be treated as a USRPI. Temporary Reg. §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 (1) at least 50 percent of the value of the partnership's gross assets consists of USRPIs, and (2) 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. The corporation is a USRPHC under Code Sec. 897(c)(2), so its shares are USRPIs.

But an interest in an LLC holding the same assets would *not* be a USRPI. While 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 Code Sec. 1445(e)(5). [Temporary Reg. §1.1445-11T(d).] 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 portion of the LLC's total value.

California: LLC Interests as Intangibles

California taxes nonresidents on their gross income derived from California sources. [R&TC Sec. 17951(a).] 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. [Reg. §17951-3.]

Does this broad language extend to gain from the sale of an *interest in an LLC* that owns California real estate? The general answer appears to be no.

R&TC Sec. 17952 says that a nonresident's income "from stocks, bonds, notes, or other intangible personal property" is not California-source income unless (1) the property has acquired a business situs in California, or (2) 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, but California joins a number of other states in characterizing partnership interests as intangible property. [*See Valentino v. Franchise Tax Board*, 87 Cal. App. 4th 1284, 1295 (2001).] The State Board of Equalization (SBE), California's administrative tax tribunal, has treated limited partnership interests as intangibles. Interests in LLCs are likely to be viewed the same way.

Hence, we should not expect gain from the sale of an interest in Realco 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. Reg. §17952(c) states that intangible personal property has a business situs in California only if (1) the intangible "is employed as capital" in California, or (2) 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 attach 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 incurred in a California business. For example, a lender to Realco 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. Reg. §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* [18 Cal. 2d 218 (1941)], in which 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 decisions of the SBE involving partnerships, there must be some act by the nonresident owner to employ the value of the intangible in a California business.

The FTB has had trouble accepting this. It periodically litigates the point, contending that simply conducting business in California through a passthrough entity meets the *Holly Sugar* standard.

The SBE has correctly rejected the FTB's arguments. Deriving value from *ownership of an interest* in an LLC conducting business in California is simply not the same thing as employing the value of an LLC interest to *conduct* a California business. [*See Appeal of Michael J. Bills*, [SBE docket 610028; 782397] (May 24, 2016); *Appeal of Amyas and Evelyn P. Ames*, 87-SBE-042 (June 17, 1987).]

Absent special facts involving business situs, a nonresident member who sells his interest in Realco should not be subject to California income tax on his gain. With no California tax, income tax withholding is irrelevant. [For a more detailed discussion of the authorities, *see* Robert W. Wood, *California Sourcing and M&A*, THE M&A TAX REPORT, Feb. 2013.]

Real Estate Withholding Under California FIRPTA?

There is one more piece to the puzzle. In 1991, California adopted its *own* version of FIRPTA. Under R&TC Sec. 18662(e)(2), anyone purchasing a "California real property interest" (CRPI) from a domestic nonresident must withhold 3 1/3 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 interest in Realco? As a general matter, withholding on the sale seems dubious because California does not normally 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. The buyer and its counsel will be expecting to withhold under FIRPTA if the LLC 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 it begs the question of whether the nonresident's membership interest *is* in fact a CRPI. We need to look at the statute.

R&TC Sec. 18662(e)(5) defines "California real property interest" 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."

Is an interest in Realco an "interest in real property" within the meaning of Code Sec. 897(c)(1)(A)(i)? The regulations discuss this term without ever mentioning passthrough entities. [*See* Reg. §1.897-1(d)(2).] This would be a startling omission if Code Sec. 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 Code Sec. 897(c)(1)(A)(i), what would be the point of Code Sec. 897(g) and Temporary Reg. §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 Code Sec. 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 Realco is *not* a "California real property interest" within the meaning of R&TC Sec. 18662(e)(5). Consequently, real property withholding should *not* apply when a nonresident member sells his interest in Realco. The result makes policy sense because California does not usually tax nonresident sales of LLC interests in the first place.

Final Thought

The U.S. corporate tax rate may be headed down, but LLCs, partnerships, and other passthroughs are here to stay. The states are probably not going anywhere, either. This means that figuring out how other states tax nonresident members of a passthrough is going to remain a significant part of tax practice.

Our romp through the state and federal tax law illustrates (and perhaps illuminates) some of the major approaches to taxing and withholding on the nonresident individual members of an LLC. We should bear in mind, however, that something as simple as adding a *corporate* member would increase the complexity of the analysis by a significant factor.

Still, one has to start somewhere. Whether we find ourselves in California or Kalamazoo, we all have our work cut out for us.

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