



# California Real Property Journal

OFFICIAL PUBLICATION OF THE REAL PROPERTY LAW SECTION

STATE BAR OF CALIFORNIA

Vol. 24, No. 2

[www.calbar.ca.gov/rpsection](http://www.calbar.ca.gov/rpsection)

## **INSIDE THIS ISSUE...**

### **Will Eminent Domain for Redevelopment Purposes Survive Legislative Challenges After Kelo? . . . . . 3**

By Steven R. Meyers, David W. Skinner, and Christopher J. Brophy

*Use of the power of eminent domain has played a crucial role in property assemblage, development, and elimination of blight for the redevelopment of California's inner cities. This article discusses the Kelo jurisprudence, its precedent in California and the United States Supreme Court, and the current political and popular reaction to the Kelo decision that may fundamentally change the manner in which California rebuilds for the future.*

### **Using a Series LLC in California . . . . . 10**

By Scott Gunderson

*This article discusses the Nevada series limited liability company and how it can be used in California.*

### **Property Taxes and Legal Entities . . . . . 13**

By Craig Dziedzic

*This article discusses the triggering of a tax assessment when real property is transferred to or by a legal entity, as well as when ownership interests in legal entities which hold real property are transferred.*

### **SB 800 and the Calderon Act: When Statutes Collide . . . . . 15**

By Joan M. Cambray and Amanda M. Steiner

*This article addresses the overlap of the pre-litigation procedures of the Calderon Act and SB 800, discusses the advantages and disadvantages of each, and suggests ways to reconcile the statutes.*

### **Tenants in Common: Are TIC's Taking Over the World? . . . . . 26**

By Darryl Steinhaus

*This article discusses the tenancy in common structure of investing in real estate, and the tax, securities and real estate issues that must be addressed when it is used by investors acquiring property in a IRC Section 1031 exchange.*



**DISTRIBUTED AT NO EXTRA CHARGE TO MEMBERS OF  
THE REAL PROPERTY LAW SECTION OF THE STATE BAR OF CALIFORNIA**

**The statements and opinions herein are those of the contributors and not necessarily those of the State Bar of California, the Real Property Law Section, or any government body.**

---

# Using a Series LLC in California

*By Scott Gunderson*  
©2006. All Rights Reserved.

## I. INTRODUCTION

Attorneys generally recommend that their clients own real estate in some type of business entity, typically a limited liability company ("LLC"). One of the purposes of this method of ownership is to isolate the potential liabilities associated with real estate from the entity and the client's other assets. If a client owns several properties, attorneys will commonly recommend that each property be owned by a separate business entity, again to limit the potential liability of each property to the assets of that separate entity. Clients are often reluctant to follow this advice due to the expense of creating multiple entities, the complications created by owning multiple entities, the cost of preparing income tax returns each year for each entity, and the exposure to annual franchise taxes and filing fees for each entity.

## II. THE SERIES LLC

A series LLC is a single entity which allows for the creation of a separate "series" of interests within it. Each series may hold different assets, have different members or managers, have different voting rights, as well as different profit and loss distribution requirements. The series LLC was first introduced in Delaware in 1996 and has since been adopted by many jurisdictions, including Nevada, Illinois, Iowa, Tennessee, and Oklahoma. Each of these jurisdictions has a similar statutory framework but there are variations in filing requirements, fees, and reporting. The Nevada statute is modeled after the Delaware statute and is typical of the law of other jurisdictions. It will be used in the balance of this article.

The Nevada Series LLC<sup>1</sup> is formed by filing the appropriate form with the Nevada Secretary of State, with a statement attached that declares that the company will have one or more series of members and that the debts and liabilities of any series are to be enforceable against that series of assets only and not against the assets of another series, or the company generally. It also declares that the relative rights, powers, and duties of each series is set forth in the operating agreement.<sup>2</sup> The series LLC should have an operating agreement which allows for the creation of more than one series. The agreement should specify members, managers, voting rights, transferability, purpose, profit and loss distributions, dissolution, and winding up for each series. The agreement may also provide for the creation of future series to be used upon the acquisition of additional property. No new filing is required to add or dissolve a series in Nevada.

Certain formalities in the operation of the Nevada Series LLC need to be observed in order to enjoy the protection of the statute. Assets associated with each series must be "held directly or indirectly, including through a nominee or otherwise and accounted for separately from the other assets of the company and any other series."<sup>3</sup> The company must also maintain separate and distinct records for each series.<sup>4</sup>

Nevada LLC law is generally more favorable for clients than California LLC law in at least two key areas. First, under Nevada

law, a charging order is the exclusive remedy for a creditor in a successful claim against an LLC interest.<sup>5</sup> Under California law, a court may authorize foreclosure on the charging order, resulting in liquidation of the client's interest and exposing the assets of the LLC to the creditor.<sup>6</sup> Secondly, default provisions in the Nevada statute will allow for higher valuation discounts than similar default provisions of California law. Specifically, Nevada law requires a unanimous vote by the members of the LLC to liquidate the LLC,<sup>7</sup> whereas California law allows a liquidation on the vote of a simple majority of the members.<sup>8</sup> The more restrictive liquidation requirement under Nevada law should result in a higher valuation discount for a member's interest.

The advantages of the Nevada Series LLC to the client are clear, but what are the risks?

## III. USE OF THE NEVADA SERIES LLC IN CALIFORNIA

Should a California resident who owns California real estate hold that real estate in a Nevada series LLC? How will the California courts look at the operation of the series LLC? The rights of managers and members? Buy-sell provisions? Internal governance? Will the California courts recognize the separateness of each series in a claim against one of the series? How will the Franchise Tax Board (FTB) tax the series LLC?

### A. Taxation of the Series LLC in California

Franchise Tax Form 568 is used to report the income and expenses of LLC's to California. Instructions contained in the package for the 2005 tax year specify that "(e)ach series in a Delaware Series LLC is considered a separate LLC and must file its own Form 568 Limited Liability Company Return of Income and pay its own separate LLC annual tax and fee if it is registered or doing business in California." Presumably, these instructions apply to series LLC's created in jurisdictions other than Delaware. This position by FTB is supported by Revenue Ruling 55-416, a tax court case from 1949<sup>9</sup> and various private letter rulings based on these "early" authorities. It is interesting that FTB would rely on these authorities, all of which address the proper taxation of regulated investment companies as that term is defined in IRC 851 and taxation of certain publicly traded partnerships as corporations under IRC 7704. The term "series" certainly appears in these code sections but refers to a series of regulated and registered securities issued by publicly traded investment companies. It is difficult to ascertain the applicability of these rulings to private LLC's, but perhaps clarification on this point is forthcoming from FTB.

Under California law the FTB does have the authority to aggregate the income of "commonly-controlled" LLC's for the purpose of assessing the gross receipts tax if it finds that multiple entities were created for the primary purpose of reducing the fees payable to the state.<sup>10</sup> However, there is no similar statutory authority to deconstruct a single entity into multiple entities. It is also unclear how the treatment of each series as a separate

LLC can be reconciled with the laws of the state under which the series LLC was formed. Certainly, Nevada law treats a series LLC as a single entity, regardless of the number of series.

Whether the FTB position is correct will likely be the subject of litigation. But for now, it intends to collect the annual franchise tax from each series of a series LLC registered or doing business in California.

Another interesting development has occurred recently in the taxation of LLC's in California. A California Superior Court judge has held that California's gross receipts tax<sup>11</sup> imposed on all LLC's is unconstitutional and violates both the Commerce Clause and Due Process Clause of the U.S. Constitution.<sup>12</sup> The tax was determined to be unconstitutional because it is applied to all LLC's registered in California, even those with no business operations in California, and applies to their "worldwide" earnings, with no apportionment for revenue earned in California.<sup>13</sup> FTB intends to appeal this decision.

### B. Treatment of Foreign Entities in California

In general, the California courts defer to the laws of the state or country where the entity was formed for questions arising out of the internal affairs of the entity.<sup>14</sup> The internal affairs doctrine is a "conflict of laws principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs matters peculiar to the relationships among or between the corporation and its current officers, directors and shareholders because otherwise a corporation could be faced with conflicting demands."<sup>15</sup> "States normally look to the State of a business' incorporation for the law that provides the relevant corporate governance general standard of care. In general, courts in California follow this rule and apply the law of the state of incorporation in considering claims relating to internal corporate affairs."<sup>16</sup> The U.S. Supreme court has held that under the commerce clause a state "has no interest in regulating the internal affairs of foreign corporations."<sup>17</sup>

California has a statute which addresses this matter for LLC's. The law states that

[T]he laws of the state or foreign country under which a foreign limited liability company is organized shall govern its organization and internal affairs....<sup>18</sup>

However, if more than 25% of the members of the foreign LLC reside in California, then those members are entitled to all information and inspection reports provided in Corporations Code Section 17106, regardless of the law of the foreign jurisdiction on this issue.<sup>19</sup> The companion statute governing foreign limited partnerships has this same provision,<sup>20</sup> but the companion statute for foreign corporations is very different.

The statute for foreign corporations in California provides for numerous exceptions to the laws of the foreign jurisdiction in the event that the average of the property factor, payroll factor, and sales factor is greater than 50%, and more than 50% of the outstanding securities are held of record by persons with address in California.<sup>21</sup> The exceptions to the foreign jurisdiction laws under these circumstances are quite broad and relate to many internal governance issues such as election of directors, removal of directors, directors' standard of care, unlawful distributions, annual shareholder meetings, supermajority voting

requirements, reorganizations, and dissenter rights to name a few.<sup>22</sup>

From the statutory framework, it seems that California has elected to apply the laws of the foreign jurisdiction relating to internal affairs, at least for LLC's and limited partnerships. The legislature could have chosen to take the path outlined in the foreign corporation statute, but did not. This should result in some predictability in this area and some degree of assurance for the client that the laws of Nevada will control the internal affairs of the LLC.

The bigger question may be the treatment of each series as independent of each other for claims by third parties. The governing statute in California states that "[T]he laws of the state or foreign country under which a foreign limited liability company is organized shall govern...the liability and authority of its managers and members."<sup>23</sup> A plain reading of this statute would seem to indicate that Nevada law would control the issue of liability of the members and managers of a Nevada Series LLC registered to do business in California. However, there are no published opinions in California which have applied this statute. The Nevada Series LLC statute requires that in order to receive the protection afforded by this entity, the managers and members must strictly abide by the statutes. Assets must not be commingled between series, separate books and accounts must be maintained, and the articles of organization must have the required disclosures concerning the "series" nature of the LLC. If those conditions are met, then under Nevada law, "[t]he debts, liabilities, obligations, and expenses incurred, contracted for or otherwise existing with respect to a particular series are enforceable against the assets of that series only; and not against the assets of the company generally, or any other series...."<sup>24</sup>

Another factor to consider is the recent pronouncement by FTB that each series of an LLC is considered a separate LLC for tax purposes.<sup>25</sup> This position would certainly bolster the argument that California will also treat each series as a separate entity for asset protection purposes.

### IV. CONCLUSION

The Nevada Series LLC may be the right entity to recommend to a client with multiple liability producing assets, including real estate. It can afford asset protection and isolation at a fraction of the cost and complexity of traditional multiple entity planning, and it can allow for flexibility in management of future activities of the client.



*Scott Gunderson is a sole practitioner in Reno, Nevada, and is certified as a Specialist in Estate Planning Trust and Probate Law by the State Bar of California, Board of Legal Specialization. He is admitted to practice in California and Nevada.*

### ENDNOTES

- <sup>1</sup> Nevada Revised Statutes Chapter 86, et. seq.
- <sup>2</sup> NRS 86.161(e).
- <sup>3</sup> NRS 86.296(3).
- <sup>4</sup> NRS 86.296(3).
- <sup>5</sup> NRS 86.401.
- <sup>6</sup> Corporations Code section 17302.

<sup>7</sup> NRS 86.491.

<sup>8</sup> Corporations Code section 17350.

<sup>9</sup> *National Securities Series – Industrial Stock Series v. Commissioner*, 13 T.C. 884, 1949.

<sup>10</sup> California Revenue & Taxation Code section 17942, subdivision (b)(2).

<sup>11</sup> *Id.*

<sup>12</sup> *Northwest Energetic Services, LLC v. California Franchise Tax Board*, Case No. CGC-05-437721.

<sup>13</sup> *Id.*

<sup>14</sup> *State Farm Mutual Auto Insurance Co. v. Superior Court* (2003) 114 Cal.App.4th 434.

<sup>15</sup> *Id.* at 442.

<sup>16</sup> *In Re Sargent Technology, Inc.* (N.D.Cal. 2003) 278 F.Supp.2d 1079, 1087.

<sup>17</sup> *Edgar v. MITE Corp* (1982) 457 U.S. 624.

<sup>18</sup> Corporations Code section 17450, subdivision (a).

<sup>19</sup> Corporations Code section 17453.

<sup>20</sup> Corporations Code section 15691 and 15694.

<sup>21</sup> Corporations Code section 2115, subdivision (a).

<sup>22</sup> Corporations Code section 2115, subdivision (b).

<sup>23</sup> Corporations Code section 17450, subdivision (a).

<sup>24</sup> NRS 86.296.

<sup>25</sup> Instructions for CA FTB form 568 page 4, Paragraph F.



VISIT THE  
REAL PROPERTY LAW  
SECTION WEBSITE

*Information*  
*Resources*

*Events*



[www.calbar.ca.gov/rpsection](http://www.calbar.ca.gov/rpsection)