

CALIFORNIA LIMITED LIABILITY COMPANY REVIEW

LLC FEE: DEALER REAL ESTATE

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The California LLC Fee, enacted as Cal. R&T Code Section 17942, requires that the cost of goods sold be added back to gross income to determine the total income of an LLC subject to the LLC Fee. So must a California LLC add back the tax basis of real property (dealer real property) held for sale to customers in the ordinary course of business? The answer is not free from doubt, but arguably "no."

Section 17942 does not define cost of goods sold. However, the statute indirectly refers to gross income under federal law as defined in IRC Section 61.

Treasury Regulation Section 1.61-3 is entitled "gross income derived from business." It defines gross income from a manufacturing or merchandising business as total sales, less the cost of goods sold, which is to be determined in accordance with the method of accounting consistently used by the taxpayer.

However, Treasury Regulation Section 1.61-6 is entitled "gross income derived from dealings in property." It states that gross income includes gain

realized on the sale or exchange of property, unless excluded by law and refers to IRC Section 1001 for determining the amount of the gain or loss. IRC Section 1001 defines gain or loss as the difference between the amount realized and the adjusted tax basis of the property. Moreover, an example in the Regulation explains that a dealer in real property must equitably apportion the tax basis of a single property to separate subdivided lots. So it seems like a stretch to include the tax basis of dealer real property in cost of goods sold under those provisions.

This conclusion is further borne out by the calculation of cost of goods sold under Schedule A of FTB Form 568. That form uses "inventory" at the beginning and ending of the year and identifies the method used for valuing closing inventory. Longstanding authorities, though, hold that real property is not merchandise that a taxpayer can inventory. See for example Rev. Rul. 86-149 and *Homes by Ayers v. Comm'r*, 795 F.2d 832 (9th Cir. 1986).

Confusion arises because the federal tax forms do not clearly separate dealer real property from inventory. Taxpayers must use Schedule

4797 to report gains and losses from the sale of property used in a trade or business, including ordinary income property, but not property primarily for sale in the ordinary course of business. Schedule D only reports capital gains. Therefore, it appears that the federal forms, to which the California forms have generally conformed, require reporting of dealer real property as inventory. The FTB Form 568, LLC Fee Worksheet follows that reporting format, which would include the tax basis of that property in the cost of goods sold added back in determining the amount of the LLC Fee.

I am currently discussing revisions of the forms with the IRS to include dealer real property on Form 4797 and I raised this issue for inclusion in Proposed Regulations for the LLC Fee.

The preceding discussion should not be construed as legal or tax advice or representation on specific legal matters, but rather as a general commentary on the subjects discussed. Your questions and comments are always welcome.