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CALIFORNIA VS. NEVADA

Should California-Based Businesses and Residents Incorporate in Nevada?

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California-based clients often wish to incorporate in Nevada because of its purported tax benefits, limited reporting and disclosure requirements, and superior liability protection as compared to California. The reality, however, is that incorporating in Nevada offers little value in most instances for California-based businesses and residents. This article briefly explains why, and, in doing so, cautions that incorporating in Nevada may not yield the benefits corporate clients desire.

NEVADA CORPORATIONS OPERATING IN CALIFORNIA ARE LIKELY SUBJECT TO CALIFORNIA LAW

Generally speaking, the laws of the state of organization (*e.g.*, Nevada) govern the business and internal affairs of a corporation. However, businesses primarily operating in California are, in most instances, governed by California law despite incorporating in Nevada. Consequently, many of the perceived benefits of Nevada law will not be realized by the client.

In California, any corporation incorporated in Nevada is a "foreign corporation."[1] A Nevada corporation ("Nevada-Corp"), however, will be classified as a "pseudo foreign corporation" if certain criteria indicating California activities are satisfied.[2] If a Nevada-Corp is deemed a pseudo foreign corporation, California law will supersede Nevada law in certain key areas, including laws governing corporate formalities, limitation of liability, indemnification, standard of care, and shareholder voting rights. In essence, California would treat the Nevada-Corp as if it had incorporated in California to begin with.

Even if the Nevada-Corp does not qualify as a pseudo foreign corporation, California still requires all foreign corporations that "transact intrastate business" within California to first qualify with the California Secretary of State ("SOS").[3] California defines "transact[ing] intrastate business" to generally mean entering into "repeated and successive" transactions within California.[4]

A Nevada-Corp transacting business in California that fails to qualify faces potentially grave consequences. Most notably, the corporation will not have standing to file a lawsuit in connection with any of its intrastate business in California state court until it has qualified with the California SOS and paid all related penalties, fees, and taxes.[5] Meanwhile, the corporation can still be named a defendant in any civil action arising in California.[6] Similarly, any contract made in California by a Nevada-Corp that either fails to qualify or file a tax return is voidable at the request of the other party.[7] A Nevada-Corp which transacts intrastate business without qualifying is also subject to monetary penalties, including a fine for each day that unauthorized intrastate business is transacted and misdemeanor fines to the corporation and any person transacting intrastate business on its behalf.[8]

TAXES

Proponents of incorporating in Nevada tout there is no corporate or personal

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income tax.[9] However, these tax benefits vanish if the shareholder is a California resident. Indeed, a California resident pays California tax on all of his/her income, even if that income is derived from activities outside of California.[10] As such, California residents wishing to form a Nevada Subchapter S corporation must keep in mind that s/he will be taxed on all of the profits (and compensation) that s/he receives because the profits will pass through to the shareholders.[11]

Alternatively, a Nevada "C" corporation could be formed. But this alternative has three principal disadvantages that must be carefully weighed. First, although the "C" corporation will not pay Nevada income tax, it still must pay federal income tax on any generated profits.[12] Second, if the client receives wages or dividends from that corporation and is a California resident, the client will pay California income tax on the funds received.[13] Worse yet, the dividends will be subject to "double taxation."[14] Third, California will tax a Nevada-Corp on income it earns in California.[15]

It also bears mentioning that if a Nevada-Corp is deemed a pseudo foreign corporation or otherwise transacts intrastate business, the company must pay corporate filing fees and franchise taxes that virtually mirror those amounts it would have incurred had it incorporated in California in the first place. For California-based businesses, therefore, incorporating and maintaining the corporation in Nevada will add an additional layer of cost and, as touched upon next, administrative burden.

MINIMAL REPORTING REQUIREMENTS

Contrary to popular belief, the reporting and disclosure requirements in California and Nevada for corporations are virtually identical. Upon formation, every California corporation must file with the California SOS, within 90 days after incorporating (and biennially thereafter), a Statement of Information. The Statement contains the name of the corporation, names and addresses of its officers and agent for service of process, and a description of the business. In comparison, every Nevada-Corp must file with the Nevada SOS, on or before the first day of the second month after incorporating (and annually thereafter), an Annual List of Officers and Directors. This Annual List contains nearly the same information as the Statement of Information.[16]

PERSONAL LIABILITY PROTECTION

The belief that shareholders are better protected from litigation in Nevada rather than California is a myth. In both California and Nevada, a shareholder's personal liability for the obligations of the company is generally limited to his/her investment in the company.[17] California and Nevada law also both recognize the alter-ego doctrine,[18] and apply similar tests in evaluating whether it may be invoked.[19]

Both states also allow shareholders to eliminate or limit the personal liability of a director or officer to the corporation and its shareholders as a result of any act or failure to act in his/her capacity as a director or officer. While Nevada provides this protection as a matter of default,[20] California affords the protection by allowing corporations to include the necessary protections in its articles of incorporation.[21]

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CONCLUSION

This article highlights only a handful of reasons why incorporating in Nevada offers little value for California-based businesses and residents. While Nevada law offers certain advantages to *Nevada* residents and businesses, most of these benefits do not apply to their California counterparts. Therefore, any California-based business and/or resident leaning towards incorporating in Nevada should give pause; after careful analysis, they will likely discover that these benefits do not apply at all.

ENDNOTES

1 California Corporations Code §§ 167, 171.

2 California applies two tests to a foreign, non-public corporation that, if met, would subject it to California law. (Cal. Corp Code § 2115(a).) The first test examines whether the proportion of the corporation's property, payroll, and sales in California compared to the company's total property, payroll, and sales equate to more than 50 percent during its latest full income year. (Cal. Corp Code § 2115(a)(1).) The second test examines whether the corporation's outstanding voting securities are held by persons having California addresses more than 50 percent. (Cal. Corp Code § 2115(a)(2)).

3 Cal. Corp. Code § 2105(a).

4 Cal. Corp Code §§ 191, 15901.02(a)(1) and 17708.03.

5 Cal. Corp. Code § 2203(c).

6 Cal. Corp. Code § 2203(a).

7 Cal. Rev. & Tax Code § 23304.1.

8 *See* Cal. Corp. Code §§ 2203, 2258-2559.

9 Barbara K. Cegavske, *The Nevada Advantage*, NEVADA SECRETARY OF STATE (Jan. 19, 2016), https://nvsos.gov/index.aspx?page=422.

10 Cal. Rev. & Tax Code § 17041.

11 *See* 11 U.S.C. §§ 1363, 1366.

12 *See* 26 U.S.C. § 11; *See also* IRS Form 1120 Instructions for 2014. https://www.irs.gov/pub/irs-pdf/i1120.pdf.

13 *See* Cal. Rev. & Tax Code § 17041.

14 A primary drawback of a "C" corporation is that shareholders are subject to "double taxation." Profits are first taxed at the corporate level. Thereafter, when they are distributed to shareholders in the form of dividends, they are taxed again. (See 26 U.S.C.A. § 336(a)).

15 *See* California Form 100 and Schedule R.

16 *Compare* California Statement of Information Form SI-100 *with* Initial/Annual List of Officers and Directors Form pursuant to Nevada Revised Statutes § 78.152.

17 *See* NRS § 78.747; Friedman, et al, Cal. Practice Guide: Corporations (the Rutter Group 2015) par. 2:38, p. 2-21.

18 The alter-ego doctrine permits courts to disregard the corporate entity and its shield against liability, and hold the individual shareholders liable for the actions of the corporation when the corporate form is used to perpetuate a fraud. *See* NRS § 78.747(2); *Hasso v. Hapke*, 227 Cal. App. 4th 107, 155-157 (2014).

19 *Compare Rowland v. Lepire*, 99 Nev. 308, 316-317 (1983) *with Sonora Diamond Corp. v. Superior Court*, 83 Cal. App. 4th 523, 538 (2000). Both States look to the totality of circumstances, and require a finding that not piercing the corporate veil under the circumstances of the case would sanction a fraud or promote injustice. They also both examine whether there is such a unity of interest and ownership between the corporation and shareholder that the separate personalities do not in reality exist.

20 *See* NRS § 78.138(7).

21 Cal. Corp. Code § 204(a)(10).

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