

SALT

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Current State of The States

WATCH

California Court Declares LLC Fee Unconstitutional

Background and Impact on California Taxpayers and Registrants

Within the past seven months, the California Superior Court in San Francisco has ruled in two separate cases that the California LLC fee is an unconstitutional tax that is unfairly apportioned in violation of the U.S. Constitution's Due Process and Commerce Clauses. *Northwest Energetic Services LLC v. California Franchise Tax Board*, California Superior Court for San Francisco County, No. CGC-05-437721 (April 13, 2006), and *Ventas Finance I, LLC v. California Franchise Tax Board*, California Superior Court for San Francisco County, No. CGC-05-440001 (November 7, 2006).

Although nearly all of the court's analysis is set forth in the decision for *Northwest Energetic Services*, the court reached its decision in both cases based on two primary reasons: (1) the LLC applied to all LLCs organized or legally qualified to do business in California, even if an LLC did not have business activities in the state; and (2) the LLC did not allow companies that operate in other states to apportion the fee. The Franchise Tax Board ("FTB") has appealed the *Northwest Energetic Services* decision to the California Court of Appeals. Briefs are scheduled to be filed by next week. It is likely that the FTB will appeal the *Ventas Finance* decision as well, but the FTB has until mid-February to make such a decision. If appealed, it is likely that the cases will be consolidated on appeal.

In reaching its decision that the fee is unconstitutional, the court analyzed whether the LLC fee is a tax versus a levy. The court noted and documented the legislative history, including the purpose of the levy and the use of its proceeds, to reach the conclusion that the LLC fee is a tax.

The court went on to state that as a tax, the LLC fee is

subject to the fair apportionment standards of the Due Process and Commerce Clause standards. The court found that the LLC fee failed the internal and external consistency tests traditionally used to determine whether a tax is fairly apportioned. The court reasoned that interstate commerce plainly would bear a greater burden than intrastate commerce if the levy was imposed by every state (*i.e.*, the internal consistency test). The court also reasoned that because the levy taxes those companies that lack any activity in California, the levy "reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State" (*i.e.*, the external consistency test).

The only connection the taxpayer in *Northwest Energetic Services* had to the state of California was that it was registered to do business with the Secretary of State. The taxpayer conducted all of its business activities in Washington and Oregon, and it was organized under the laws of Washington. The taxpayer in *Ventas Finance*, however, conducted business in California as well as other states. The court ruled the application of the LLC fee to both taxpayers was unconstitutional because the amount of the fee was not based on their apportioned gross receipts to California.

The court went further in *Ventas Finance* by finding that the statute regarding the LLC fee cannot be reformed. The court noted that the legislative history shows the Legislature considered and rejected apportionment of the LLC fee, thus the addition of such a provision now would run contra to the Legislature's expressed intent. The court recognized that reformation of an unconstitutional statute is an exception to be narrowly construed and applicable only in circumstances that are not present with the LLC fee.

Section 17492 of Cal. Rev. & Tax. Code imposes a fee on every LLC subject to tax under Cal. Rev. & Tax.

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Code § 17491. Section 17491 subjects LLCs to tax if they are “doing business” in the state, if their articles of organization have been accepted by the Secretary of State or if they have received a certificate of registration from the Secretary of State. The LLC fee calculation is based on “total income from all sources reportable in this state for the taxable year.” Cal. Rev. & Tax. Code § 17492(a). The court found that this provision considers total income without apportionment.

The LLC fee was enacted in 1994 as part of the California Limited Liability Act (S.B. 469). The LLC fee was intended to generate additional tax revenue to compensate for income tax revenue projected to be lost as a result of the enactment of LLCs.

Action Items

Those LLCs affected by *Northwest Energetic Services* and *Ventas Finance* should consider filing protective refund claims with the FTB. The FTB has released special instructions for filing claims related to this issue. Such claims will be held in abeyance pending the outcome of the FTB’s appeal to the California Supreme Court. The filing of a protective refund claim, however, will preserve the right to refund and protect against claims being barred by the statute of limitation.

An LLC affected by the court decisions includes one that (1) has filed Form 568, California LLC Return of Income, (2) paid the LLC fee within the previous four years, and (3) are treated as partnerships or disregarded entities for federal income tax purposes.

GBQ will continue to monitor this development, as necessary. GBQ SALT professionals are available to assist you in determining how best to address issues your company may have regarding these court decisions. Current year returns for the LLC fee should continue to be computed based on the law as currently written in Cal. Rev. & Tax. Code § 17942 (*i.e.*, total income).

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