California Court of Appeal Affirms that LLC "Fee" Violated Commerce Clause

May 2008
by Peter B. Kanter, Scott M. Reiber

Related Practices:
- State and Local
- Tax

On January 31, 2008, the California Court of Appeal issued a decision in *Northwest Energetic Services, LLC v. Franchise Tax Board ("Northwest")*.[1] As described below, the court of appeal upheld in part and reversed in part the trial court's decision,[2] which struck down California's LLC Levy[3] under Revenue and Taxation Code former Section 17942.[4] Most importantly, the court of appeal affirmed the portion of the trial court's decision finding that the LLC Levy was an unconstitutional tax in violation of the Dormant Commerce Clause of the United States Constitution.

Background
The Levy imposed by former Section 17942 was referred to as an "annual fee" by the statute, and was imposed on "every limited liability company subject to tax under Section 17941." Thus, the Levy applied to any LLC that did business in California during the tax year or that had registered to do business in California with the Secretary of State. The amount of the Levy ranged from a minimum of $900 to a maximum of $11,790 per year. Pursuant to former Section 17942, the amount owed depended on the taxpayer's "total income from all sources reportable to [California] for the taxable year," which the Franchise Tax Board ("FTB") construed to mean gross receipts earned anywhere in the world.

Northwest Energetic Services, LLC ("NES") was a Washington LLC in the business of distributing explosives and providing explosive-related services. It had no operations, property, inventory, employees, agents, independent contractors, nor a place of business in California, solicited no customers in California, and made no deliveries to California. Nevertheless, it was subject to the Levy in former Section 17942 by virtue of having registered to do business in California with the Secretary of State in 1997. While it paid the $800 minimum tax under Section 17941 for the years at issue, NES did not pay the amount due under former Section 17942 until the FTB sent notice that NES was liable for $27,458.13, plus penalties and interest, for tax years 1997, 1999, 2000, and 2001. After paying this amount and exhausting its administrative remedies, NES filed a claim for refund with the superior court on the grounds that the Levy imposed by former Section 17942 was unconstitutional because it violated the Commerce Clause and Due Process Clause of the United States Constitution. The superior court agreed with NES and granted its claim for refund for the full amounts paid under former Section 17942. The superior court also awarded NES attorneys' fees under California Code of Civil Procedure ("CCCP") Section 1021.5 and the common fund doctrine.

The FTB appealed the decision of the superior court with respect to its decision both on the constitutionality of former Section 17942 and on its award of attorneys' fees. With respect to the constitutionality of former Section 17942, the FTB contended that, because the Levy was a fee and not a tax, the Levy did not violate the Commerce Clause and Due Process Clause of the United States Constitution. With respect to the attorneys' fees issue, the FTB argued that: (1) CCCP Section 1021.5 and the common fund doctrine were inapplicable to NES's claim for refund; (2) NES did not satisfy the requirements of CCCP Section 1021.5 and the common fund doctrine; and (3) the trial court erred in its determination of the amount of the attorneys' fees awarded.

The Levy in Former Section 17942 Was Unconstitutional as Applied to NES
The court of appeal first affirmed that former Section 17942 imposed a tax and not a fee, despite the fact that the former statute referred to the Levy as an annual "fee."[5] The court stated that the

relevant analysis in determining whether the Levy was a tax or a fee was "whether the Levy [was] a compulsory payment imposed for the purpose of raising revenues for general governmental purposes, or whether it fund[ed] a regulatory program or compensate[d] for government services or benefits voluntarily sought by the LLC."[6]

The court of appeal noted that the legislative history of the California Limited Liability Company Act demonstrated that the Levy was promulgated for general revenue purposes, the proceeds from the Levy were deposited into the general fund, and the Legislature specified that the Levy was to be administered in the same manner as California's income taxes, rather than under procedures specific to the administration of fees. The court also rejected the FTB's arguments that the Levy was intended to fund a regulatory program because there was no indication in the evidence that this was the case, and there was no nexus between the Levy and any regulatory program expense. Additionally, the court concluded that the Levy was not required in exchange for benefits NES received from California.

After finding that the Levy was a tax, the court of appeal then concluded that the tax, as applied to NES during the years at issue, violated the Commerce Clause of the United States Constitution.[7] The court of appeal indicated that former Section 17942 violated both the internal and external consistency tests, which are used to determine whether a tax is fairly apportioned under the Commerce Clause, as interpreted by the Supreme Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The court of appeal found that the Levy was internally inconsistent because if the same levy were imposed in every state, "an LLC engaging in business in multiple states with the same total income as Northwest would pay the maximum levy in every state in which it did business or registered to do business. An LLC operating only in one state would pay the maximum levy only once."[8] Similarly, the court of appeal found the Levy to be externally inconsistent because it "'reach[ed] beyond that portion of value that is fairly attributable to economic activity within the taxing State.'"[9] Because the Levy violated both the internal and external consistency tests, the court of appeal concluded that it violated the Commerce Clause.[10]

The court of appeal thus affirmed the trial court's decision granting NES's claim for refund. However, the court of appeal cautioned that "[a]s a general matter, only the portion of the Levy that exceeds Commerce Clause limits must be refunded."[11] While this amounted to all of the amounts paid by NES under former Section 17942 because none of NES's gross receipts would have been apportioned to California, it suggests that the courts may apply an apportionment formula retroactively to those taxpayers that conducted business both within and outside California.[12] Indeed, current Section 17942, which was amended in response to the trial court's decision in this case, provides that its apportionment provision will apply retroactively. It is unclear whether such retroactive application will pass constitutional muster, however, as discussed in the court of appeal's decision in *City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th 518 2005) (*"NMI"*) (finding that the Due Process Clause prohibited the City's attempt to apply a retroactive apportionment scheme to a previously unapportioned tax).[13]

The Importance of the Decision

The court of appeal found that while NES is entitled to attorneys' fees, the superior court erred in its determination of the amount of such fees to award. NES's attorneys represented the taxpayer on a contingency-fee basis, and the superior court awarded NES $3.5 million in attorneys' fees under CCCP Section 1021.5 and the common fund doctrine. Section 1021.5 provides a means by which taxpayers may bring suits where the amount at issue for them personally may not justify the attorneys' fees required to litigate the case, but where the benefits of the litigation to the public or a class of persons are sufficient to justify such attorneys' fees. The court of appeal agreed that CCCP Section 1021.5 applied to NES's case because of the substantial benefits the litigation conferred on other LLCs that did business in or were registered to do business in California.[14] However, the court of appeal reversed the trial court's upward adjustment of the calculated hourly fees of NES's attorneys from $219,566.95 to $3.5 million because it found that the trial court had not provided sufficient explanation for the adjustment. The court of appeal therefore remanded the attorneys' fees issue to the trial court for further consideration of the appropriate upward adjustment, if any.

Unless the FTB successfully petitions the California Supreme Court to review the court of appeal's decision, the ruling should resolve for good the constitutionality of former Section 17942. However, taxpayers and tax authorities are anxiously awaiting the court of appeal's decision in the other case brought to challenge former Section 17942, under facts whereby the taxpayer had income attributable to California as well as to other states. That case, *Ventas Finance I, LLC v. Franchise Tax Board ("Ventas")*,[15] will likely decide the issue of whether the FTB and other tax authorities may limit refunds issued for unconstitutionally unapportioned taxes to the amounts the taxpayer would not have paid had the tax been apportioned at the outset.

Claims for Refund Based on *Northwest*

LLCs that had no business activities in California and LLCs that did business both within and outside of California should consider filing refund claims soon with the FTB to ensure that any open claims are not barred by the statute of limitations. The FTB recently published FTB Notice 2008-2, which lists the information that LLCs with facts similar to NES (i.e., no activities in California) must provide in their refund claims in order to have such refund claims processed. The notice also lists additional information that LLCs that previously filed refund claims must provide to show that they did no business in California so that their refund claims may be processed immediately, rather than waiting for a final decision in *Ventas*. FTB Notice 2008-2 may be found at http://www.ftb.ca.gov/law/notices/2008/2008_2.pdf.

Footnotes:

[1] *Northwest Energetic Servs., LLC v. Franchise Tax Bd.*, 159 Cal. App. 4th 841 (Cal. App. 2008).

[2] The trial court's decision is discussed in detail in Peter B. Kanter, *California's LLC Tax: Current Litigation and Retroactive Legislation*, Morrison & Foerster Legal Updates & News, March 2007, http://www.mofo.com/news/updates/files/8917.html.

[3] Taxpayers and the FTB had disagreed as to whether former Section 17942 imposed a "fee" or a "tax." For simplicity, we will follow the court of appeal's practice and use the term "Levy."

[4] As the court of appeal in *Northwest* noted, Section 17942 was amended in 2007 to apportion the LLC Levy. *See* 2007 Cal. Stat. ch. 381, § 2. As in the court of appeal's decision, we will refer to the statute at issue in this case as "former Section 17942." All further section references in this article are to the California Revenue and Taxation Code, unless otherwise noted.

[5] While the court ultimately concluded that the Levy was a tax and not a fee, in footnote 12 of the decision it indicated that "we do not share the view that it makes a difference whether the Levy is characterized as a tax or a fee for Commerce Clause purposes."

[6] *Northwest*, 159 Cal. App. 4th at 854.

[7] Because this determination disposed of the case, the court of appeal did not reach the question whether former Section 17942 was unconstitutional on its face, or whether it violated the Due Process Clause.

[8] *Northwest*, 159 Cal. App. 4th at 862.

[9] *Northwest*, 159 Cal. App. 4th at 864. (quoting *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995)).

[10] The FTB raised arguments that the Levy was constitutionally valid under the balancing test enumerated in *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) ("*Pike*"), and that NES could have chosen to operate as a corporation, rather than an LLC, such that it would not have been subject to the unapportioned tax (relying on *United States Borax & Chemical Corp. v. Carpentier*, 150 N.E.2d 818 (Ill. 1958) ("*Carpentier*")). The court of appeal dismissed the argument under *Pike* on the grounds that *Pike* did not involve a tax or fee, so it was inapplicable to NES's claims and, even if it were applicable, the Levy would not satisfy *Pike*'s balancing test. *See Pike*, 397 U.S. at 142. The court of appeal dismissed the argument under *Carpentier* because the taxpayer's choice in *Carpentier* (i.e., whether to be taxed based upon its property and business in the state or based upon the taxpayer's entire stated capital and paid-in surplus) was fundamentally different from a taxpayer's choice to operate as an LLC. *See Carpentier*, 150 N.E.2d at 825-27.

[11] *Northwest*, 159 Cal. App. 4th at 868 n.16 (citing *Macy's Dep't Stores, Inc. v. City & County of San Francisco*, 143 Cal. App. 4th 1444, 1449-50 (Cal. Ct. App. 2006) ("*Macy's*")). Although the court of appeal cites *Macy's* for the proposition that the remedy may be limited to the amount that the tax exceeded the limits of the Commerce Clause, an LLC that has conducted business both within and outside California may distinguish *Macy's* on the grounds that the *Macy's* decision dealt with tandem taxes, in which the taxes were only unconstitutional when applied in conjunction with

each other, and there was no issue with respect to the calculation of the tax that Macy's would have owed had the tax scheme been applied in a constitutional manner. *See City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th 518 (Cal. Ct. App. 2005) ("*NMI*") (ruling that applying retroactive apportionment to remedy an unconstitutional tax may violate due process requirements due to the inherent difficulties in calculating proper apportionment for past years).

[12] In *Ventas Finance I, LLC v. Franchise Tax Board*, A116277 (Cal. Ct. App., 1st App. Dist., filed May 16, 2007) ("*Ventas*"), an LLC that conducted business both within and outside California challenged the LLC Levy on grounds similar to those of the taxpayer in *Northwest*. *Ventas* is currently pending before the court of appeal and will likely determine the issue of the remedy for taxpayers that conducted business both within and outside California.

[13] A more complete analysis of the *NMI* decision's application to the retroactive LLC fee may be found at Peter B. Kanter, *California's LLC Tax: Current Litigation and Retroactive Legislation*, Morrison & Foerster Legal Updates & News, March 2007, http://www.mofo.com/news/updates/files/8917.html.

[14] While the court of appeal agreed that CCCP Section 1021.5 applied to NES's case, it determined that NES did not meet the requirements of the common fund doctrine because there was no common fund for it to preserve. *See Serrano v. Priest*, 20 Cal. 3d 25 (Cal. 1977).

[15] *Ventas Finance I, LLC v. Franchise Tax Bd.*, No. A116277 (Cal. Ct. App., 1st App. Dist., filed May 16, 2007).