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California's LLC Tax: Current Litigation and Retroactive Legislation

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Section 17942 of California's Revenue & Taxation Code [1] imposes an annual levy [2] on all limited liability companies ("LLC") registered to do business in the state. Currently, the levy is unapportioned, such that an LLC's liability for the fee is set by its total gross receipts worldwide, rather than its income attributable to business within California. The San Francisco Superior Court in *Northwest Energetic Services, LLC v. Franchise Tax Board* [3] ("*Northwest*") found the unapportioned levy unconstitutional, and awarded Northwest Energetic Services a full refund of the amounts it had paid under section 17942. While the superior court's decision in *Northwest* is legally binding only for the taxpayer that brought the suit, because California's Franchise Tax Board ("FTB") recently sought review of the trial court's decision, the case will likely determine the fate of section 17942 on appeal. Similarly, another case challenging the constitutionality of section 17942 under different facts, *Ventas Finance I, LLC v. Franchise Tax Board* [4] ("*Ventas*"), was recently decided by the San Francisco Superior Court. As in Northwest, the San Francisco Superior Court in *Ventas* ruled that section 17942 is unconstitutional because it is not apportioned.

In the wake of the *Northwest* decision, the California legislature proposed amendments to section 17942 in an attempt to remedy the unconstitutionality of the statute (A.B. 1614). The amended version of section 17942 would have continued to impose an annual levy on LLCs doing business in California; however, the amount owed would have been apportioned based on the amount of business that each taxpayer actually did within the state. Had the proposed amendments become law, they expressly would have applied retroactively as of 2001. Under the proposed amendments, some LLCs that paid the unapportioned levy in years 2001-2005 might have been entitled to a full refund. However, many would have received only a partial refund or no refund at all, depending upon the extent of the LLC's business activities in California. However, under the 2005 ruling by the California Court of Appeal in *City of Modesto v. National Med, Inc*. [5] ("NMI"), the retroactive apportionment provision in the proposed amendments may itself have been unconstitutional. [6]

This article describes the challenges to section 17942 raised by the taxpayers in *Northwest* and *Ventas,* and discusses whether the legislature's proposed amendments to section 17942 would have been an adequate solution in light of the Court of Appeal's decision in *NMI*.

Section 17942

The levy imposed by section 17942 is referred to as an "annual fee" by the statute, and it is imposed on "every limited liability company subject to tax under Section 17941." [7] The amount of the levy ranges from a minimum of $900 to a maximum of $11,790 per year. [8]

As discussed in detail below, section 17942 is problematic in that it applies to any LLC that either does business in California or has simply registered to do business in California, and its rate is applied without regard to the amount of business the taxpayer actually does within the state during a given year. [9]

Recent Litigation

Northwest Energetic Services, LLC v. Franchise Tax Board

In *Northwest*, the Superior Court for the City and County of San Francisco awarded plaintiff Northwest Energetic Services ("NES") a refund of $27,458.13, the total amount it had paid pursuant to section 17942 for tax years 1997, 1999, 2000, and 2001. The plaintiff, an LLC, was in the business of distributing explosives and explosive-related services. The plaintiff maintained business locations in Washington and Oregon only, and had no business activity, property, inventory, employees, or customers in the State of California. Nevertheless, it was subject to section 17942's levy by virtue of having registered to do business in California with the Secretary of State in 1997.

NES paid California's flat $800 minimum franchise tax under section 17941 for the four years at issue. However, NES did not pay anything under section 17942 until 2002, when the FTB notified NES that it owed a total of $27,458.13, including penalties and interest under the LLC fee provision. NES paid the full amount in order to receive a Tax Clearance Certificate, then promptly cancelled its registration in California and sought a refund of the taxes paid, which the FTB denied. On administrative appeal, the State Board of Equalization upheld the denial of NES's refund claim. Having exhausted its available administrative remedies, NES filed suit challenging the constitutional validity of section 17942, both on its face and as applied.

At trial, NES argued that the levy was a tax, not a fee, and that the tax was unconstitutional because it was not apportioned. The FTB maintained that section 17942 imposed a regulatory fee rather than a tax, and therefore it need not be apportioned, on the grounds that LLCs voluntarily decide how to organize and whether to register in California in exchange for privileges and benefits afforded by the state. The trial court decided in favor of the taxpayer on both issues.

The court first determined that section 17942 imposes a tax and not a fee, despite the fact that the statute refers to the levy as an annual "fee." The court explained that the determination of whether a levy is a fee or a tax is based upon its operation and intent, not upon its label. Taxes raise revenue for the state's general use, whereas fees are paid into specialized funds associated with a particular state service. Furthermore, fees serve to reimburse the state for specific costs associated with providing some benefit, service, or regulation, and cannot require the collection of more than the amount reasonably necessary to cover the cost of the state's regulatory activities. [10]

The court reviewed the legislative history underlying section 17942 and determined that the primary purpose of the levy was to replace lost corporate income tax revenue. When the California Limited Liability Company Act ("LLC Act"), S.B. 469, which recognized limited liability companies as legal entities in California, became effective in 1994, the legislature added section 17942 to offset the anticipated drop in corporate income tax revenue. The legislature deliberately set the amount of the levy so that it would make up for the projected decrease in corporate income tax revenues from businesses deciding to operate as LLCs rather than as corporations in California. The court found support for its conclusion that the levy is a tax in the fact that the levy generates far more revenue than necessary to support the state's administrative activities related to regulating and administering LLCs. Furthermore, the court noted that the revenue generated by the levy goes into California's general fund, not toward the state's regulation or administration of LLCs. For these reasons, the court held that the FTB had not met its burden of proving that the levy was a regulatory fee rather than a tax. [11]

Having found that the levy imposed by section 17942 was not a fee but a tax, the trial court ruled that, as applied to NES, section 17942 violates the United States Constitution's fair apportionment requirement. [12] The court stated: "A fundamental constitutional principle governing state taxation . . . is that a state tax must be fairly apportioned, i.e., it must be calibrated to the level of activity in the State." [13]

Grounded in Commerce Clause and Due Process principles, the requirement of fair apportionment is a two-fold requirement. First, the fair apportionment requirement mandates that a state tax place no greater burden on interstate commerce than on intrastate commerce. [14] Second, it forbids states from taxing any income not attributable to in-state economic activity. [15]

The court found that the unapportioned levy violated both prongs of the fair apportionment requirement. First, the levy burdened interstate commerce as compared to intrastate commerce because if every state enacted a statute identical to section 17942, LLCs registered to do business in multiple states would pay more tax overall than LLCs doing business in only one state. [16] Second, since section 17942 required NES to pay California taxes despite the fact that it had not done business in the state, the levy "undeniably" reached beyond NES's income attributable to business activities within California. [17]

Although the facts in *Northwest* were extremely favorable to the plaintiff, as the taxpayer had no sales, property, or employees in California, the FTB filed notice on July 5, 2006, of its intent to appeal the trial court's decision. [18] The California Court of Appeal for the First Appellate District sitting in San Francisco will review the case on appeal.

Ventas Finance I, LLC v. Franchise Tax Board

Ventas involved the same apportionment issue as Northwest. However, the facts of Ventas were somewhat different, since the plaintiff in Ventas carried on a small amount of business in California, while NES had none.

Ventas, an LLC organized under Delaware law with its headquarters in Louisville, Kentucky, sued for a refund of payments it made under section 17942 based on the grounds that the amounts paid were disproportionate to the amount of Ventas's business activities in California. Ventas's complaint alleged that if California's corporate franchise tax apportionment methodology were applied, Ventas's California apportionment percentage would have been 8.06%, 8.34%, and 6.94% in the years 2001, 2002, and 2003, respectively. [19] However, pursuant to section 17942, the tax base for Ventas's LLC tax was its total worldwide gross receipts and it paid levies of $6,000 in 2001 and of $11,790 (the maximum possible) for each of the years 2002 and 2003. Like the plaintiff in *Northwest,* Ventas filed an administrative claim for refund, which was denied. Ventas's lawsuit sought a refund in the amount of $29,540, plus interest and attorneys' fees. [20] The FTB's answer again maintained that the levy imposed by section 17942 was a fee, not a tax. As noted above, the *Northwest* court expressly rejected that contention.

The court in *Ventas* again determined that the levy imposed pursuant to section 17942 was a tax, not a fee. The court made this determination on the same grounds as it had in *Northwest*; namely, that the purpose of the levy is to raise revenue and that the revenue raised was used for general purposes, not to fund the regulation of LLCs. The court then found that the levy imposed by section 17942 was unconstitutional as applied to Ventas because it was not fairly apportioned. Lastly, the court held that section 17942 could not be reformed because "[a]dding an apportionment mechanism as [the Franchise Tax Board] suggests would run contra to the Legislature's expressed intent" because the legislative history of section 17942 "establishes that the Legislature considered and rejected apportionment" of the levy.

While the facts in *Ventas* differed from those in *Northwest*, the Commerce Clause analysis was the same in each case. The Northwest court found that section 17942 burdened interstate commerce more than intrastate commerce because if every state enacted a statute identical to section 17942, LLCs registered to do business in more than one state would have greater overall tax liability than those choosing to do business in only one state. This would be true regardless of whether a particular plaintiff conducts a small amount of business, as opposed to none at all, in California. Under a fair apportionment tax statute, Ventas would have to pay some LLC tax in California by virtue of having done some business there, but presumably the apportioned amount would be less than the amounts it paid for tax years 2001 through 2003 pursuant to the unapportioned tax based on its worldwide business.

The final decision in the *Northwest* appeal should determine the fate of section 17942 as currently written. If the trial court's decision is upheld on appeal, LLCs registered to do business in California will not be subject to the unapportioned levy on a going forward basis, and LLCs that paid the unapportioned tax in past years will be able to claim refunds for those payments. However, the proposed retroactive provision in A.B. 1614 had made it unclear whether those taxpayers would be entitled to full refunds of all amounts paid under section 17942, or whether they would be limited to claiming amounts paid in excess of the apportioned tax A.B. 1614 sought to create.

Proposed Changes to Section 17942

Retroactive Apportionment

Recognizing that *Northwest* could very well be upheld on appeal, the California Senate and Assembly passed A.B. 1614, which contained proposed revisions to section 17942, including an apportionment provision that would have modified section 17942 to bring it in line with constitutional fair apportionment requirements. However, with little forewarning, Governor Schwarzenegger vetoed the bill on September 30, 2006.

Had it been signed by the Governor, the modified statute would have defined "total income from all sources reportable to this state" to mean gross income plus the cost of goods sold, but only to the extent that such income and sales are "derived from or attributable to" the State of California. The

proposed revisions also would have provided that LLCs would calculate their income derived from or attributable to the state according to the general apportionment provisions in sections 25101 *et seq.*, which apply to state income and franchise taxes. [21]

However, the proposed statutory revision was problematic in that it would have applied to taxpayers retroactively starting for the 2001 tax year. While the apportionment of the LLC fee under A.B. 1614 might have rectified the constitutional infirmity identified in Northwest, retroactive changes present constitutional problems of their own, as explained in *NMI*.

The underlying issue in *NMI* was similar to that in *Northwest*, although *NMI* involved an unapportioned municipal business license tax rather than a statewide tax. While the California Constitution does not contain an explicit commerce clause, courts have found nevertheless that municipal taxes discriminating against intercity commerce are unconstitutional under due process and equal protection principles. [22] Whereas the taxpayer in *Northwest* sued for a refund of taxes paid, in *NMI* the City of Modesto was attempting to collect an alleged business tax deficiency from the taxpayer. At trial, the court rejected the City's claim, finding the business license tax unconstitutional as applied to NMI because it was unapportioned and, thus, it unfairly taxed income earned outside the City. On appeal, the City did not deny that its tax as originally drafted was unconstitutional, but instead asked the court to sanction a retroactive legislative change that would allow it to pursue its claim against NMI, albeit for a reduced amount that would reflect NMI's apportioned business within the City.

In addition to finding that the plain language of the City's tax ordinance restricted the retroactive application sought by the City, [23] the court in *NMI* invalidated the retroactive apportionment provision of the business license tax on constitutional due process grounds. The City argued that retroactively apportioning the business license tax would not threaten the plaintiff's right to due process, because it could only have the effect of lowering a taxpayer's liability. The court, however, pointed out that due process requires that taxpayers have "a fair opportunity to challenge the accuracy and legal validity of their tax obligation and also a clear and certain remedy for any erroneous or unlawful collection." [24] The court noted that retroactive application of the apportionment provisions would have required NMI to prove which of its gross receipts were earned outside the City and thus not includable in the tax base of the City's business license tax. [25] Because the retroactive provision, enacted in 2004, would have applied as far back as 1996, taxpayers in NMI's position would have had to produce records eight or nine years old to avoid being unconstitutionally taxed on income earned outside the City. The court held that this was a far cry from a "clear and certain remedy," and that it placed an unfair burden on the taxpayer to correct the City's error in originally drafting an unapportioned tax. Notably, the court also stated that California courts generally allow retroactive changes to tax laws only if they are limited *to the current tax year*. [26]

Under the due process analysis in NMI, the Legislature's proposed changes to section 17942 probably would not have been able to withstand constitutional challenge. In order to avoid being forced to pay unapportioned taxes, taxpayers like NES and Ventas would have been required to produce out-of-state business records from tax years 2001 forward that they had no obligation to retain. The *NMI* court found this requirement unfair to taxpayers, who must have fair notice of any record-keeping obligations required to establish a constitutional right. [27]

Furthermore, the retroactive apportionment of the levy under section 17942 would have applied as of 2001, a retroactive period of five years. As noted above, the *NMI* court cited *Gutknecht* and *Carlton* in support for the general rule that California courts allow "retroactive application of tax laws only where such retroactivity [is] limited to the current tax year." [28]

However, there are reasons to be cautious about the application of *NMI*'s "current year" rule. First, the majority in *Carlton* did not establish a bright-line rule regarding the allowable length of retroactivity periods. Instead, it was Justice O'Connor's concurring opinion that stated that a "period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise . . . serious constitutional questions." [29] Second, *Gutknecht* is at least arguably limited to its facts – *i.e.*, retroactive increases in the tax rate – and may not apply to A.B. 1614, which attempted to rectify the constitutional infirmity of an existing statute. Further, Gutknecht was decided prior to Carlton, and there do not appear to be any California cases other than NMI that interpret Carlton with respect to retroactivity of tax legislation. Third, in 1996 the Ninth Circuit Court of Appeals, which has jurisdiction over federal cases in California, held that there was no due process violation for federal legislation applying retroactively for approximately three years because the legislation was supported by a legitimate legislative purpose furthered by rational means. [30] In other words, while *NMI* suggests that California courts will allow retroactive application of tax

legislation only if it is limited to the current tax year, it is possible that a court could allow a longer retroactivity period.

In *NMI,* the City was barred from collecting tax under a statute that was unconstitutional during the years at issue in the lawsuit. Based on the reasoning of the court in *NMI*, California should not be allowed to apply an apportionment provision retroactively and collect an apportioned tax under section 17942, since the tax was unconstitutional when paid. Therefore, taxpayers should be entitled to refunds of the full amounts previously paid under section 17942, not just the amounts paid over and above the tax they would have paid had it been fairly apportioned at the time.

Taxpayer Remedies

California has already established an administrative process for LLCs to file protective refund claims in the wake of the *Northwest* decision. Taxpayers who plan to seek refunds should file protective claims immediately, despite the possibility that *Northwest* will be reversed on appeal, as the statute of limitations to file claims for refund will expire within four years of when the tax was paid. [31]

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Footnotes:

1 All references to "section" are to the California Revenue and Taxation Code, unless otherwise noted.

2 Taxpayers and the FTB disagree as to whether section 17942 imposes a "fee" or a "tax." For simplicity, we will follow the *Northwest* court's practice and use the term "levy."

3 Case no. CGC-05-437721; final decision issued on April 18, 2006.

4 Case no. CGC-05-440001; tentative decision issued on November 7, 2006.

5 27 Cal. Rptr. 3d 215 (Cal. Ct. App. 2005).

6 On September 30, 2006, Governor Schwarzenegger vetoed A.B. 1614, noting that the validity of section 17942 was pending before the courts. While A.B. 1614 appears now to be defunct as a result of the Governor's veto, the retroactivity problems it raised are sure to arise again in future legislative amendments, and thus, are still worthy of analysis.

7 Section 17941 imposes a separate levy on every limited liability company "doing business in [California] (as defined in Section 23101)." Pursuant to section 23101, "doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."

8 The amount owed depends on the taxpayer's "total income from all sources reportable to [California] for the taxable year," which both taxpayers and the FTB have construed to mean gross receipts earned anywhere in the world.

9 Readers should note that the section 17942 levy is separate from, and in addition to, the $800 per year flat minimum franchise tax imposed on LLCs under section 17941.

10 *See Sinclair Paint Co. v. State Bd. of Equalization*, 937 P.2d 1350, 1353 (Cal. 1997).

11 The court held that the burden of proving the levy is a fee rather than a tax falls on the State, though the plaintiff retains the overall burden of proving the unapportioned levy is unconstitutional.

12 The *Northwest* court held that, even if it had deemed the levy a fee, "it would be subject to the fair apportionment requirement of the Commerce and Due Process Clauses of the United States Constitution." In support, the court cited *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 285 (1987) (in which the U.S. Supreme Court applied constitutional apportionment requirements to an annual identification marker fee assessed on each vehicle of certain weight classes operating on the state's highways), and *American Trucking Ass'ns, Inc. v. Michigan Public Service Comm'n*, 545 U.S. 429 (2005) (in which the Court applied constitutional apportionment requirements to a flat $100 annual fee on trucks engaged in intrastate commercial hauling).

13 Under *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977), a levy on interstate commerce must be "fairly apportioned."

14 *See, e.g., American Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987); *American Trucking Ass'ns v. New Jersey*, 852 A.2d 142 (N.J. 2004).

15 *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995) (holding that a traditional sales tax need not be apportioned even when applied to the gross proceeds of an interstate service, but that gross receipts or gross income taxes do require apportionment).

16 The court thus applied what the United States Supreme Court labeled the "internal consistency" test in *Jefferson Lines*. *See Jefferson Lines*, 514 U.S. at 184.

17 This, the court said, violated the "external consistency" test of *Jefferson Lines*. *Id.* at 184.

18 The Notice of Appeal was filed with the Court of Appeal on August 8, 2006. The appellant's opening brief is due on December 12, 2006.

19 When a corporation conducts taxable business activities both inside and outside of California, that corporation must apportion its taxable business income based upon the apportionment formula laid out in sections 25128 *et seq*. Pursuant to section 25128, a taxpayer's apportionment percentage is equal to the sum of (1) the taxpayer's property factor, (2) the taxpayer's payroll factor, and (3) two times the taxpayer's sales factor, divided by four.

20 The body of plaintiff's complaint alleged payments totaling $29,580, but the prayer for relief asked for $29,540.

21 *See* note 20, above.

22 *See City of Los Angeles v. Shell Oil Co.*, 480 P.2d 953 (Cal.), *cert. denied*, 404 U.S. 831 (1971).

23 Until NMI filed its trial brief, the City's amended business license tax ordinance provided for retroactive apportionment only in the context of taxpayer refund claims. After NMI filed its trial brief, the City added a retroactive apportionment provision that would have applied to deficiency assessments initiated by the City, including the deficiency assessment at issue in the underlying suit against NMI. The trial court disallowed the retroactive change because the new apportionment provision constituted a substantive change to the ordinance, and the City's tax ordinance itself provided that only procedural changes could apply retroactively.

24 27 Cal. Rptr. 3d at 223 (citing *McKesson Corp. v. Florida Alcohol & Tobacco Div.*, 496 U.S. 18 (1990) (internal quotations omitted)); *see also Atchison, Topeka & Santa Fe Ry. v. O'Connor*, 223 U.S. 280, 285 (1912).

25 *Id.*

26 *Id.* at 222 (citing *Gutknecht v. City of Sausalito*, 117 Cal. Rptr. 782 (Cal. Ct. App. 1974)); *see also United States v. Carlton*, 512 U.S. 26 (1994).

27 *See, e.g., Patel v. City of Gilroy*, 118 Cal. Rptr. 2d 354, 357 (Cal. Ct. App.), *cert. denied*, 537 U.S. 1072 (2002) ("A tax law in particular 'must prescribe a standard sufficiently definite to be understandable to the average person who desires to comply with it.'" (citation omitted)).

28 27 Cal. Rptr. 3d at 222.

29 512 U.S. at 38 (O'Connor, J., concurring).

30 *Montana Rail Link, Inc. v. United States*, 76 F.3d 991, 995 (9th Cir. 1996).

31 The authors would like to acknowledge the substantial contributions to this article made by

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