

Client Alert

Tax

San Francisco Superior Court Rules California LLC Tax Unconstitutional

March 30, 2006

A San Francisco trial court has issued a tentative ruling concluding that California's R&TC section 17942 levy on LLCs is an unconstitutional tax. *Northwest Energetic Services, LLC vs. California Franchise Tax Board* (San Francisco Sup. Ct. No. CGC-05-437721, March 3, 2006) .

The case concerned a Washington state LLC that never had any sales, property, payroll or any other activity in California, other than registering with the California Secretary of State. The taxpayer had paid the annual \$800 minimum tax under Revenue and Taxation Code (R&TC) section 17941, but refused to pay the R&TC section 17942 levy, based on gross income from all LLC sources, both in and out of California. When assessed \$27,453 for six years of back tax, interest and penalties, the taxpayer paid the assessment and sought a refund. After being denied relief by the State Board of Equalization (which concluded it had no authority to address constitutional issues; SBE No. 236696, October 19, 2004), the taxpayer sued for refund in superior court.

The court first concludes that this 'levy' is a tax, not a fee. The court found that the levy bore no relationship to either the California benefit provided the taxpayer or the burden imposed on California. Indeed the California legislature specifically provided separate LLC filing fees to cover administrative costs. The court noted the levy was well beyond any potential regulatory cost as the annual proceeds generated by R&TC section 17942 exceed the entire budget of the California Secretary of State. Finally, the R&TC section 17942 legislative history verifies that this 'levy' was intended to replace tax revenues lost by business usage of new LLC flow through entities rather than C Corporations.

The court then concludes this LLC tax violates the Commerce Clause and Due Process Clauses of the United States Constitution because it is based on worldwide gross receipts and not apportioned between income sourced within and without California. The court notes this failure to calibrate the tax to the taxpayer's California activity violates the four part test of *Complete Auto Transit v. Brady* 430 U.S. 274, 279 (1977) (taxed activity must have nexus to the state, be fairly apportioned, not discriminate against interstate commerce and be fairly related to state provided services). The tax also fails to satisfy the required internal and external consistency tests as duplicate taxation would occur if other states applied the same taxing regime. See *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.* 514 U.S. 175, 189 (1995).

The FTB has asked the trial court to reconsider its decision, filing a March 20, 2006 brief claiming (among other things) that R&TC section 17942 is truly a fee (rather



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than a tax) because it is only imposed on those LLCs that choose to do business in California (suggesting that all California taxes are truly fees because they are all paid by businesses choosing to operate in California). Accordingly, the FTB will no doubt continue to enforce and collect the R&TC section 17942 tax as long as any avenue of appeal remains. Even if the FTB was not contesting the decision, it would not be binding precedent as it is only a trial court decision. We also note that the *Northwest Energetic* taxpayer had no California source income or any other California presence. While the decision appears to conclude that R&TC section 17942 is an unconstitutional tax on all LLCs, including those with California activities, it remains uncertain whether a California court would be as willing to conclude the tax was unconstitutional for an LLC that generated all (or most) of its income from California sources.

Practitioners have long thought that R&TC section 17942 was subject to constitutional challenge because of its failure to apportion the tax base between in-state and out-of-state activity. The California Franchise Tax Board (FTB) recently published guidance for taxpayers seeking to file protective refund claims (Cal. CCH Par. 403-983, March 16, 2006). Taxpayers seeking to protect their right to recover past R&TC section 17942 taxes need to file refund claims within four years of paying the tax. R&TC section 19301 et. seq. We would recommend that taxpayers with LLCs paying the R&TC section 17942 tax review their particular facts and circumstances and file protective refund claims for the entire amount of the taxes paid in accordance with the recent FTB guidance. We are available to assist in computing the potential recoveries and preparing necessary refund claims.

For further information, please contact:

Jeffrey M. Vesely [\(bio\)](#)
San Francisco
+1.415.983.1075
jeffrey.vesely@pillsburylaw.com

Craig A. Becker [\(bio\)](#)
Silicon Valley
+1.650.233.4725
craig.becker@pillsburylaw.com

Kerne H.O. Matsubara [\(bio\)](#)
San Francisco
+1.415.983.1233
kerne.matsubara@pillsburylaw.com

Richard E. Nielsen [\(bio\)](#)
San Francisco
+1.415.983.1964
richard.nielsen@pillsburylaw.com

Annie H. Huang [\(bio\)](#)
San Francisco
+1.415.983.1979
annie.huang@pillsburylaw.com



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