



California LLC Fees Ruled Unconstitutional; Protective Claims Required to Preserve Refund Opportunities

Any limited liability company (LLC) that has paid California LLC Fees for any taxable years since 2001 should consider filing a protective refund claim for those years. Two California trial courts have now ruled that the levy of LLC Fees beyond the \$800 minimum annual tax violates the Due Process and Commerce Clauses of the United States Constitution. While the rulings are not yet binding precedent, refunds may well become available for the entire amount paid over the \$800 minimum tax for as many as four and possibly five prior tax years. Filing a protective claim will protect the taxpayer against a loss of rights due to the running of applicable statutes of limitations. A formal refund claim may be made once the issue has been determined finally.

Like the Internal Revenue Code, California's income tax laws generally allow an LLC to be taxed as a partnership or, in the case of single owner LLC, ignored separate from its owner. Similarly to corporations or limited partnerships, however, an \$800 minimum tax is imposed on the LLC itself for the privilege of doing business in California. An additional "LLC Fee" is also levied on each LLC in an amount that increases in steps depending on the LLC's gross receipts from all jurisdictions, regardless of whether the LLC is organized under California law or is merely qualified to do business in California. The LLC Fee caps out at \$11,790 for LLC's with more than \$5 million in gross receipts. It is that LLC Fee that may be refundable.

FAILURE TO APPORTION IS FLAW

During 2006, two different judges in two separate cases in San Francisco Superior Court ruled that the LLC Fee is unconstitutional. Each relied on *Complete Auto Transit, Inc. v. Brady*, a 1977 United States Supreme Court case, which requires that any tax imposed by a state must be based on a fair apportionment among the states from whom revenue is derived. In both the recent cases, the court found that the LLC Fee was such a tax, but did not meet the apportionment requirement of *Brady*. It was thus held unconstitutional, and

DECEMBER 2006

Washington, DC
+1 202.942.5000

New York
+1 212.715.1000

London
+44 (0)20 7786 6100

Brussels
+32 (0)2 517 6600

Los Angeles
+1 213.243.4000

San Francisco
+1 415.356.3000

Northern Virginia
+1 703.720.7000

Denver
+1 303.863.1000

This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.

arnoldporter.com

the Franchise Tax Board has been ordered to refund the LLC Fees paid by each of the taxpayers who sued. The \$800 minimum tax was not involved in either case and is likely not subject to constitutional challenge. The Franchise Tax Board has appealed both cases.

In the first case, *Northwest Energetic Services LLC v. California Franchise Tax Board*, the taxpayer had no business activities at all in California for the taxable years in question; hence, the court merely ruled that California could not impose the graduated LLC Fee on that taxpayer. The court did not need to determine a method of apportionment. In the most recent case, *Ventas Finance 1 LLC v. Calif. Franchise Tax Board*, however, the taxpayer did, in fact, derive income from California sources and the court was forced to reach the issue of apportionment. The *Ventas* court found that the legislative history of the LLC Fee statute made it clear that the California Legislature had expressly rejected the concept of apportionment when it enacted the statute. Because it could not reform the statute in the face of an express legislative intent to the contrary, it could not cure the constitutional defect. Accordingly, the court held the entire LLC Fee to be unconstitutional, regardless of whether the LLC did business solely in California or earned income elsewhere. While the two trial court decisions are

well-reasoned, it is still possible that they might not be sustained on the appeals that are now pending in both cases. If the trial court decisions are affirmed on appeal, however, all LLC's should be eligible for refunds of the LLC Fees they paid during the relevant limitations period.

OPPORTUNITIES FOR REFUNDS

In order to avoid statute of limitations bars on future refunds for prior taxable years, LLC's that have paid more than the \$800 minimum tax in California should file a protective claim with the FTB. The instructions for filing the protective claim are available on the Franchise Tax Board's website, at <http://www.ftb.ca.gov>, in the "public bulletins" section.

The statute of limitations for refunds typically expires on the later of (a) four (4) years after the later of the date the original return was timely filed (recognizing any applicable extensions) or the date the return was due without extension, or (b) one year after the date of the overpayment. Accordingly, refund claims made after October 15, 2006 can relate back to the 2002 taxable year or, in special cases, possibly the 2001 taxable year. Accordingly, the maximum amount of refund may as much as \$48,000 or more, for LLC's that had revenues exceeding \$5 million in each of those taxable years.

The California Legislature will probably adopt a new, appropriately

apportioned tax once the appellate process is resolved. Such a tax scheme passed both houses early this year, but was vetoed by Governor Schwarzenegger on the grounds that it was premature. Such an apportionment system can apply only to taxable years ending after the date of enactment. It would thus be wise for every California LLC that has paid more than \$800 per year to file the protective claim as soon as possible.

For more information contact

Ira Moskatel
+1 213.243.4223
Ira.Moskatel@aporter.com