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CALIFORNIA LLC ENTITY FEE RULED UNCONSTITUTIONAL

By Victor Sy, CPA, MBA

As you know, California has [two types of taxes](#) that are levied on LLCs that elect to be taxed as partnerships or disregarded entities:

1. Franchise [Tax](#) based on net income, and
2. Entity [Fee](#) based on gross revenues.

It is the [fee](#) that has been the subject of scorn from the business community. It is the entity fee that caused *Northwest Energetic Services, LLC* to challenge validity of this fee in court.

This is the case of an LLC that was organized in the state of Washington. It registered to do business in California. The Franchise Tax Board of the State of California computed the LLC fee based on total worldwide income – without apportionment. In other words, California taxed all of *Northwest's* gross revenues, including those earned outside California. [Northwest sued and won!](#)

The San Francisco Superior Court ruled that the fee was [unconstitutional because it was not apportioned](#). This lack of apportionment violated both the Commerce Clause and the Due Process Clause of the U.S. Constitution as well as the Due Process Clause of the California Constitution.

California FTB will probably appeal the decision. If lack of apportionment is affirmed to be unconstitutional, only multistate LLCs will benefit from the case. [If the statute itself is held invalid, all LLCs – yours and mine – will benefit from this ruling.](#)

The appellate court could overturn the lower court's decision and side with the FTB or it could side with the lower court for *Northwest*, leaving two potential outcomes:

1. The court could rule that the [entire LLC fee statute is unconstitutional](#). In this case, the result would be [no](#) LLC fee at all. The FTB would be forced to act on all refund claims from both foreign and domestic claims.
2. The court could find that the unconstitutional provision is [severable](#). The judge could find that the statute itself is valid. In this case, the decision would apply [only to LLCs doing business in multiple states](#). The FTB may be forced to allow apportionment of the fee.

Because all LLCs may be affected, you should file a [protective claim](#) for refund of fees on all years that are open under the statute of limitations. The California statute is four years; therefore, file a protective claim for the calendar years 2002, 2003, 2004, and 2005. You may still file a claim for 2001 returns that were extended beyond April 15, 2002.

[Fax the following data to dedicated fax number \(916\) 845-9796:](#)

1. LLC name, address, and Secretary of State number.
2. A statement that the letter constitutes a protective claim.
3. The taxable years.
4. The grounds for claim (that the entity fee is unconstitutional based on the Northwest Energetic Services LLC decision).
5. The amount of claim (should match the entity fees that were paid),
6. A fax number for the LLC or its representative.

Remember that:

1. This ruling does not affect LLCs that elected to be taxed as corporations because they are not obligated to pay the entity fees.
2. The case only addressed the constitutionality of the entity fee, not the franchise tax of \$800.
3. The FTB will hold all claims until the final outcome of the decision.
4. For current 2005 tax returns, file as usual, pay as usual.