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## **CALIFORNIA LLC FEE HELD UNCONSTITUTIONAL**

By Victor Sy, CPA, MBA

California never liked LLCs. It was merely pushed into enacting LLC statutes when neighboring Nevada and Arizona attracted businesses to their borders. While most states passed LLC laws to **attract businesses**, true to form, California designed a **second fee** (entity fee) to tax **gross revenues** of LLCs registered in California.

California has **two types of levies** on LLCs that elect to be taxed as partnerships or disregarded entities:

1. **Franchise Tax** based on **net** income.
2. **Entity Fee** based on **gross** revenues.

It's the **entity fee** that has been the subject of scorn from the business community. Despite complaints from businesses, the state government went further to require out-of-state LLCs who did only a **fraction** of their business in California to pay the entity fee on **all gross revenues from all states**. To rub it in, the Franchise Tax Board went even further to tax LLCs that did **not even do any business in the State**, as long as it was registered in California. How cute.

As a result, **three lawsuits** were filed to challenge the constitutionality of California's LLC rules:

1. **Northwest** – an out-of-state LLC that was registered but did **not** do any business in California.
2. **Ventas** – another out-of-state LLC that did business both **in and out of California**.
3. **Bakersfield Mall** – a California LLC operating **only in California**.

**Case #1 Northwest** entity fee was ruled **unconstitutional** by a California Court of Appeals early this year for taxing an out-of-state LLC that did **not do any business in California**. Round 1 for taxpayers. The Franchise Tax Board has begun issuing refunds to LLCs that did not do any business in California.

Northwest Energetic Services, LLC was organized in the state of Washington. It registered in California and paid the franchise tax of \$800 every year. The Franchise Tax Board of the great State of California assessed Northwest about \$27,000 of entity fee based on **total** worldwide income – without apportionment. In other words, California taxed **all** of **Northwest's** gross revenues, even if none was earned in 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 Franchise Tax Board appealed..... and lost.**

**Case #2 Ventas** entity fee was also ruled to have **violated the Commerce Clause** by a California Court of Appeals. **Ventas won**. Round two to taxpayers. Affirming the lower court, the Court of Appeals held that the fee as applied to Ventas, an LLC that conducted business in California and other states, was not fairly apportioned and, therefore, violated the Commerce Clause because the levy was based on total income **without apportionment** to income attributable to, or derived from, California sources.

In the meantime a new law (AB 198) amended the old law (R&TC 17942) and changed the calculation of the LLC fee from activity in California, rather than on worldwide income.

**Case #3 Bakersfield Mall** is still pending. Stay tuned for the conclusion of the California LLC fee saga.