



LLCs Operating in California Finally Receive an Answer to the “Annual Fee” Question

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On October 10, 2007, Governor Schwarzenegger signed Assembly Bill No. 198 (“AB 198”) into law. AB 198 amends section 17942 of the Revenue and Taxation Code which provides for the imposition of an annual “total income” fee to be paid by all limited liability companies organized in California, or foreign limited liability companies registered with the California Secretary of State. Under the new amendment to section 17942, the gross receipts fee will be based only on total income from all sources derived from or attributable to California.

Background

Limited liability companies formed in California, or foreign limited liability companies doing business in California, are subject to a flat annual franchise fee of \$800.ⁱ In addition to the franchise fee, California law imposes a total income, or gross receipts, fee on all California limited liability companies not taxed as corporations, including foreign limited liability companies doing business in California.ⁱⁱ The total income fee is based on a limited liability company’s “total income,” which is defined as gross income plus cost of goods sold.ⁱⁱⁱ The amount of the fee is as follows^{iv}:

Total Income			Fee
\$0.00	-	\$249,999.99	\$0
\$250,000.00	-	\$499,999.99	\$900
\$500,000.00	-	\$999,999.99	\$2,500
\$1,000,000.00	-	\$4,999,999.99	\$6,000
>\$5,000,000.00			\$11,790

Prior to the enactment of AB 198, the total income fee was assessed on a limited liability company’s entire amount of income, including income not derived from or attributable to California. As a result, many foreign limited liability companies were forced to pay the total income fee even if only a small portion of their income came from business activities in California. Several lawsuits were filed by foreign limited liability companies challenging the Constitutionality of the total income fee. The first case to be heard was *Northwest Energetic Services, LLC v. California Franchise Tax Board*.^v In that case, the plaintiff was a limited liability company organized in the state of Washington that did not conduct any business in California. It’s only contact with California was that it was registered with the California Secretary of State. In a two-part holding, the San Francisco Superior Court ruled that the total income fee was in fact a tax because the funds were deposited into the general fund for governmental purposes and not reasonably calculated to fund a regulatory program or compensate for services provided by

and/or received from the State.^{vi} The court went on to hold that the tax violated the Due Process and Commerce Clauses of the United States Constitution because it was not fairly apportioned, i.e., calibrated to the level of activity in the State.^{vii} The court ordered that the plaintiff receive a full refund, plus interest, of all amounts paid pursuant to the total income fee.

The case was *Ventas Finance I, LLC v. Franchise Tax Board*.^{viii} In that case, the plaintiff, a Delaware limited liability company that registered to conduct business in California, derived less than 10% of its total income from its business activities in California, but nevertheless paid the total income fee based on its entire income. When the company sued for a refund of the fees, the San Francisco Superior Court ruled, along the same lines as in *Northwest Energetic Services*, that the total income fee was in fact a tax, and that it violated the Due Process and Dormant Commerce clauses of the United States Constitution because the tax was not apportioned to business income actually derived from California. On appeal, the *Ventas* court affirmed the lower court's decision and adopted the same reasoning as the court in *Northwest Energetic Services*.^{ix} However, the *Ventas* court reversed the lower court's ruling that *Ventas* was entitled to a full refund of all fees paid under former section 17942. The appellate court held that, because *Ventas*, unlike *Northwest Energetic Services*, derived some of its income from California, that the amount of the tax that was refundable was "the difference between the levy actually paid and the amount that could be collected without violating the Commerce Clause using a proper method of apportionment."^x

Assembly Bill No. 198 (2007-2008 Reg. Sess.)

After the superior court decisions in *Northwest Energetic Services* and *Ventas*, but prior to the appellate court decisions in those cases, the California Legislature passed, and the Governor signed into law, Assembly Bill No. 198 (2007-2008 Reg. Sess.). The bill effectively amends subsection (b) of Revenue and Taxation Code Section 17942 to provide that the total income fee will be based on "total income from all sources derived from or attributable to this state."^{xi} According to the amended section 17942, the total income from all sources derived from or attributable to California will be determined using the rules for assigning sales for corporations, pursuant to sections 25135 and 25136 of the Revenue and Taxation Code.^{xii} Section 25135 provides that the proceeds from the sale of tangible personal property is deemed to be attributable to California if the property is delivered or shipped to a purchaser, other than the U.S. government, within California regardless of the f.o.b. point or other conditions of sale; or the property is shipped from an office, store, warehouse, factory, or other place of storage in California and either the purchaser is the U.S. government, or the taxpayer is not taxable in the state of the purchaser.^{xiii} Section 25136 provides that the proceeds from the sale of property other than tangible property is deemed to be attributable to California if the income-producing activity is performed in California, or the income-producing activity is performed both inside and outside of California and a greater percentage of the income-producing activity is performed in California than any other state, based on costs of performance.^{xiv}

In *Ventas*, the Franchise Tax Board recently filed a petition for certiorari with the United States Supreme Court that is currently pending. In the meantime, it seems that for now, limited liability companies operating in California have a clearer picture of their tax liability under Revenue and Taxation Code section 17942.

ⁱ See Rev. and Tax Code §§ 17941(a) and 23153(d)(1).

ⁱⁱ See Rev. and Tax Code § 17941(d).

ⁱⁱⁱ See Rev. and Tax Code § 17942(b)(1).

^{iv} See Rev. and Tax Code § 17942(a).

^v California Superior Court for San Francisco County, No. CGC-05-437721, April 13, 2006 Statement of Decision, *aff'd*, 159 Cal. App. 4th 841 (2008).

^{vi} *Id.* at pp. 7-9.

^{vii} *Id.* at pp. 9-11.

^{viii} California Superior Court for San Francisco County, No. 05-440001, November 7, 2006 Statement of Decision, *aff'd*, 165 Cal. App. 4th 1207 (2008).

^{ix} 165 Cal. App. 4th at 1221-22 (“We find the reasoning in *Northwest* persuasive, adopt it as our own, and conclude that, as applied to Ventas, former section 17942 violates the Commerce Clause to the extent that it fails to provide a method of fair apportionment.”)

^x *Id.* at 1233.

^{xi} Rev. and Tax Code § 17942(b)(1)(A).

^{xii} Rev. and Tax Code § 17942(b)(1)(B).

^{xiii} See Rev. and Tax Code § 25135.

^{xiv} See Rev. and Tax Code § 25136.