as if the taxpayer had always been a resident (if that is the year-end status) or as if the taxpayer had always been a nonresident (if that is the year-end status).

NOTE: According to the FTB, you may use any other reasonable method to properly allocate the losses for the period of residency or nonresidency.

How to do it

FTB has designed worksheets and instructions to do this calculation. Even if your computer software does this calculation, you must input all the prior-year information. The only redeeming factor is that once the part-year resident period is over, the resident taxpayer will have a capital loss carryover that matches the federal number (unless there are other basis or law differences).

Next month we will discuss this process and how to calculate passive loss carryovers on the part-year resident return.

Lynn Freer

LLC "Fee" – Taxing Non-California Income

Multistate LLCs may incur large fees, regardless of California income

Clients and tax preparers may not know that if a multistate LLC decides to do business in California, it may be subject to an LLC fee of up to $11,790 — even if it has little or no gross income in this state. This article will examine how this is possible and if it is constitutional.

Background – LLC tax and fee

California imposes an annual tax of $800 on every LLC that is organized in, qualified to do business in, or actually does business in California (R&TC §17941). The state also imposes an annual fee on every LLC subject to the annual tax whose "total income" is at least $250,000 (R&TC §17942(a)).

The rate of the LLC fee has varied over the years. The 2002 fee on total income is:

Total Income:	Tax:
$0 – $250,000	$ 0
250,000 – 499,999	$ 900
500,000 – 999,999	$ 2,500
1,000,000 – 4,999,999	$ 6,000
$5,000,000 or more	$11,790

Fee on total income

The law states that the above fees must be paid "if the total income from all sources reportable to this state for the taxable year is two hundred fifty thousand dollars" (R&TC §17942). The FTB's instructions to Form 568 define "total income" as gross income plus the cost of goods sold from all sources before taking into consideration any apportionment and allocation. Thus, the California "fee" is the same regardless of the amount of California income, since it is based on what appears to be worldwide gross receipts.

If every state adopted the California tax and fee structure, an LLC that operated in every state and had $5,000,000 of gross receipts would pay total taxes and fees of $629,500 each year. If a similar LLC operated only in California it would pay a tax and fee of only $12,590 as follows:

	California	Other 49 States	Total
LLC fee	$11,790	$577,710	$589,500
LLC tax	800	39,200	40,000
Total	$12,590	$616,910	$629,500

Although the $800 annual tax is not deductible for California tax purposes, it appears that the fee (whether paid to California or another state) can be deducted against California income. See "Did You Know That...? LLC gross receipts fee deduction" in the April 1998 issue of **Spidell's California Taxletter;** and see ***Appeal of Dayton Hudson Corp*** (1994) 94-SBE-003.

Is this "fee" really a fee?

Is the LLC "fee" really a fee or it is it really a tax? That is a very difficult question. Regardless of its title, a fee is generally based on gross receipts and is imposed for a specific benefit or privilege. Taxes are usually imposed on gross or net income and are used for general purposes by the taxing authority. This LLC fee looks like a fee because it is based on gross receipts, but it does not appear to confer a privilege or benefit to the LLC. It looks like a tax because the state uses the receipts without regard to the source of the funds. Only a court can finally decide this issue.

Is it constitutional as a tax?

Assuming that the "fee" is really a tax based on worldwide total income, it does not appear to be constitutional because it violates the Commerce Clause of the U.S. Constitution. In ***Ceridian v. FTB*** (2002) 85 Cal.App.4th 875, the California Court of Appeal, citing federal cases, stated, "In order to be constitutional, a tax scheme must fairly relate to the services provided and be fairly apportion(ed) by the State." This appears to be violated since California bases its tax on worldwide income, which bears no relationship to the taxpayer's activity in this state. Another California court held that a tax must have "what might be called internal consistency — that is the [tax] must be such that, if applied by every jurisdiction, there would be no impermissible interference with free trade" (***General Motors v. Los Angeles*** (1995) 35 Cal.App.4th 1736). Thus, if this "fee" is really a tax it appears that it may be unconstitutional because California unfairly taxes worldwide receipts.

Is it constitutional as a fee?

What if the state argues that the LLC fee is really a fee? It may still be invalid since the courts have held that to be valid, a fee must be charged for a particular governmental service and the fee cannot exceed the fair compensation for the privilege for which the fee applies (***Capital Greyhound Lines v. Brice*** (1950) 339 U.S. 542, 544). Since the legislation imposes the "fee"

Did You Know That...

Voluntary Contributions

Have you ever noticed a section near the end of California personal tax returns that says "Contributions"? That is where your client can donate part of their refund or send a payment to certain charities. The California Legislature directs the FTB to collect contributions for select causes via the tax return. This practice is also common in other states. Here are a few things you should know about this process.

Only certain charities

A taxpayer may only contribute to the funds listed on the tax return. Your client cannot designate a contribution to a church, synagogue or other favorite charity unless it is on the list. There will be a total of 11 funds on 2002 personal income tax returns. For 2002, the Legislature reestablished the Asthma and Lung Disease Research Fund as a donee. It was last included in 2000 (although it was called the Lung Disease and Asthma Disease Research Fund). All the funds from the 2001 return will be on the 2002 return.

You can't change your mind

Once an amount is entered on the line, the taxpayer cannot change his or her mind. The FTB forwards the funds directly to the charity. In 2000, an early version of a small off-the-shelf tax software program contained an error that automatically designated a taxpayer's entire refund to a particular fund. The FTB was unable to retrieve the money from the charity.

Mistake on the return

If there is an error on the return and the refund is less than the amount figured by you or the taxpayer, the FTB will reduce the contribution to the lesser of the amount originally designated or the amount of the refund. If there is a balance due, the FTB will not forward the donation to the fund and will not try to collect the unused money from the taxpayer. A taxpayer may increase the balance due on the return to include the contribution. However, if the taxpayer fails to include the contribution in the payment, the FTB will not make the payment to the organization and then collect the money from the taxpayer.

not for a service provided to LLCs but instead "to make up for the income tax that is being avoided," it appears that this fee could not pass this test. Similarly, even when it upheld a large fee in ***Sinclair Paint Co. v. SBE*** (1997) 15 Cal.4th 866, the taxpayer had an opportunity to prove that the fees paid exceeded the reasonable cost of providing the services for which they were charged. It is hard to see how this test can be met with the LLC fee, which is not related to any specific benefit and which is imposed on worldwide gross receipts. Thus, even if this is a fee, it appears to be excessive in amount and therefore possibly an invalid fee.

Conclusion: What if the fee is unconstitutional?

If the fee is unconstitutional, multistate LLCs appear to have a good argument that they should only pay the fee based on their California-source total income. Unfortunately, the FTB must enforce the statute until it is judicially invalidated since an administrative agency has no power to declare a statute unconstitutional (Cal. Const., Article III, §3.5, subds. (a) and (b)). Thus, a taxpayer who takes that position on a tax return may be audited and will probably have to go to court to assert that the law is unconstitutional, unless there is either a legislative change (clarification) or the FTB reinterprets the meaning of the term "reportable to this state" to include only California-source gross receipts.

Richard Malamud

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Household Employers

Reporting requirements

Hiring that nanny to take care of the kids after school and that gardener to manicure the lawn may be conveniences, but they may also make you or your client a "household employer," subject to some inconveniences from the tax collector.

Household employers must register with the EDD and report household employees by filing Form DE 1HW, **Registration Form for Employers of Household Workers**, when they employ one or more individuals and pay cash wages of $750 or more in a calendar quarter. Household employers must also file Form DE 34, **Report of New Employee(s)**, for each new employee within 20 days of hire.

Household employers who pay less than $20,000 in wages per year may elect to pay taxes annually by checking the "yes" box in Item I on Form DE 1HW or, if previously registered with the EDD, may complete Form DE 89, **Employer of Household Worker Election**.

NOTE: Annual taxpayers must file quarterly reports, but may pay annually. Household employers who have elected to pay taxes annually for 2002 must file the fourth-quarter DE 3BHW, **Quarterly Report of Wages and Withholdings for Employers of Household Workers**, and Form DE 3HW, **Annual Payroll Tax Return for Employers of Household Workers**, by January 31, 2003. Any balance due must be paid with Form DE 3HW by January 31, 2003. Household employers who have not elected to pay annually must use the same forms as nondomestic employers; i.e. Forms DE 6, DE 7 and DE 88. See the chart below for details.

Household employers must give a Form W-2 to their employees by January 31, 2003, and must submit Form W-3 with Form W-2 to the Social Security Administration by February 28, 2003. Employers are not required to send state copies of Form W-2 to the EDD or the FTB.

Online services

There are online subscription services, such as Nanny Tax USA (see Web site below) that allow you or your clients to easily report and file payroll records for household employment taxes. Generally, after you enter basic information into an online account, the online service keeps the information in a database and uses it to calculate taxes and to determine what forms,

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Complexities of Capital Loss Carryovers

FTB has worksheets to help – you'll need it!

Preparation of 2002 part-year resident tax returns will be a challenge. AB 1115 (Ch. 01-920) requires a taxpayer to recompute capital loss carryover losses when he or she changes from resident to nonresident or vice versa. When we first looked at this concept, it seemed simple. But now we — and the FTB — realize it will often involve a two-step process. Here is how it works.

Old law

For taxable years beginning prior to 2002, a taxpayer who had a capital loss while a nonresident did not necessarily have a capital loss carryover for California tax purposes after becoming a resident. He was allowed a California capital loss carryover only if the transaction that gave rise to the loss had a taxable situs in California.

A taxpayer who incurred a capital loss carryover as a resident could carry capital losses with them to offset future California-source income when the taxpayer became a nonresident.

Example of Capital Loss for New Resident — Old Law

Gil became a California resident on January 1, 2001. For federal purposes he had a $20,000 capital loss carryover from 2000. The loss was from the sale of stock. He may not use the capital loss carryover in 2001 or later for California purposes because the loss was from the sale of intangibles not sourced to California.

New law

For taxable years beginning on or after January 1, 2002, a taxpayer who is a nonresident does not have a capital loss carryover for California purposes, except to the extent that California-source losses exceed California-source gains. If a taxpayer is a resident and becomes a nonresident, he or she must recompute the capital loss carryover as if he or she had always been a nonresident, excluding all gains and losses from intangible property not sourced to California (gains

In This Issue

Happy Holidays!