

# Is California's LLC Annual Fee Legal?

## Out-of-state LLC fights "gross receipts" fee

Northwest Energetic Services, an LLC based in Washington state, is challenging the constitutionality of California's annual fee because the fee applies to income from all sources. You may want to file a protective claim for refund on behalf of your LLC clients, pending resolution of the case. The case will be heard in San Francisco Superior Court and because the case will likely be appealed no matter who wins, it could be years before the issue is resolved.

The fee is calculated based on the taxpayer's total income, which includes income earned in other states (R&TC §17942). As a result, LLCs registered to do business in California must pay an annual fee based on their worldwide income, not just California-source income.

This means that if a multistate LLC does business in California, it is subject to an LLC fee of up to \$11,790, even if it has little or no gross income in this state. In the past there has been debate about whether the fee was constitutional, but it was never challenged in California courts.

Northwest appealed the fee to the Board of Equalization, based on constitutional issues (*Appeal of Northwest Energetic Services LLC* (2004) Cal. St. Bd. of Equal. Case No. 236696). Northwest registered to do business in California, but did not actually conduct any business in California during the years in question. Northwest challenged California's fee, stating that it is "unconstitutional on its face and as applied." However, the Board does not have the authority to decide constitutional issues and ruled that the fee must be calculated based on worldwide income. Northwest has now filed its case in the Superior Court of California in San Francisco.

### Is it constitutional as a tax?

Assuming that the fee is really a tax based on worldwide income, it may violate Commerce Clause of the U.S. Constitution. In *Ceridian v. FTB* (2000) 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." California's LLC fee appears to violate this since California bases the fee on worldwide income without apportionment or alloca-

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tion, 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). If every state adopted the California tax and fee structure, an LLC that operated in every state and had \$5,000,000 of total income 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 |

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?**


If the FTB argues that the LLC fee is really a "fee," and not a tax, it may still be unconstitutional since the courts have held that to be valid, a fee must be charged for a particular governmental service and cannot exceed the fair compensation for the privilege for which it applies (*Capital Greyhound Lines v. Brice* (1950) 339 U.S. 542). This fee could not pass this test, because the code imposes the fee "to make up for the income tax that is being avoided," not for a service provided to the LLC.

Similarly, even when the court 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 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 may, therefore, be unconstitutional.

**File protective claim for refund**

If you have clients who paid an increased annual fee because California-source income was less than all source income, you might wish to file a protective claim for refund before the statute of limitations expires. Write "Protective Claim" on the top of the claim for refund and note that you are appealing based on the outcome of the appeal of *Northwest Energetic Services*.

The FTB will hold the claim for refund until the Northwest issue is resolved. This may be a long shot because if Northwest loses in superior court, it may not want to spend the money to further appeal the case and the FTB will deny the refunds.

If you would like more details on the case, or would like to track its progress, visit the San Francisco court's Web site at [www.sftc.org](http://www.sftc.org) and view case number CGC-05-437721. 

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