

March 3, 2006

INFORMATION RELEASE

CALIFORNIA LLC GROSS RECEIPTS FEE IS UNCONSTITUTIONAL

Overview

A recent California superior court case (*Northwest Energetic Services, LLC v. Franchise Tax Board*, San Francisco Superior Court Case No. CGC-05-437721) has ruled that the annual LLC gross receipts fee imposed by Rev. & Tax'n Code Section 17942 is unconstitutional because the fee is based on worldwide revenue of the LLC and is not apportioned. Since the Franchise Tax Board ("FTB") has not appealed the decision, it is still unclear exactly what the final results will be and we may not know for a few years if the case goes through appeals.

While the court ruled that the fee violates the Commerce Clause and Due Process Clause of the U.S. Constitution, it is not clear whether the statute itself is invalid for whether the statute will stand if the fee is calculated using an apportionment method. If the latter, the *Northwest* decision will only affect multi-state LLCs — those with income both within and without California. If the statute is ruled invalid it will affect all LLCs that pay (and have paid) the fee.

Since it is possible that the decision may affect all LLCs, each LLC that has paid the fee should consider filing a "protective claim for refund" of the entire amount of fees for all years open under the statute of limitations. For a calendar-year LLC that filed its 2001 return by the original due date, it must file a protective claim for that year by April 17, 2006. A protective claim for refund is a unique kind of refund claim that protects the taxpayer's potential right to a refund when there is a contingency in the tax law. The LLC must protect its claim because a claim for refund must be filed prior to the expiration of the statute of limitations on refund claims.

To file a protective claim, the FTB has set up a special procedure and requested that the LLC fax a relatively simple letter that provides:

- The LLC's name, address, and Secretary of State file number
- A statement that the letter constitutes a protective claim
- The taxable year(s) at issue
- That the grounds for the claim are based on the outcome of the *Northwest* decision and that the LLC fee is unconstitutional
- The amount of the claim, which should match the amount of the annual fee that the LLC paid for each year
- A fax number that the FTB can use to contact the representative or LLC

The letter must be signed by a representative with power of attorney (POA) or signed directly by a managing member or designated person of the LLC. The POA should be completed under normal procedures. You may fax a copy of the POA along with the letter. Upon receiving the faxed letter, the FTB will send a confirmation letter stating that it has received the claim or will request additional information needed to perfect the claim.

However, the FTB cannot guarantee a confirmation letter in fewer than 21 days. As such, a better approach may be to send the protective claim for refund via certified mail, return receipt requested, to the following address:

Franchise Tax Board
P.O. Box 942857
Sacramento, CA 94257-0600

The FTB will hold the claims until the final outcome of the *Northwest* decision. If the FTB decides not to appeal the *Northwest* decision, it will deny all claims and the LLC's only recourse will be to file in court. On the other hand, if the FTB appeals the decision and loses, the FTB should make refunds of the fee.

2005 LLC Returns Due April 17, 2006

What should you do if you are filing a 2005 LLC return now? According to the FTB, it is business as usual. This means that the LLC should pay the fee, without apportioning, and file a protective claim for refund. If the LLC does not pay the fee, the FTB will send a bill and the LLC will be liable for the fee plus interest. Accordingly, if the LLC has not filed its 2005 return or paid the 2005 fee, do not include 2005 in the protective claim for refund. Rather, file a separate claim later after filing the 2005 return and paying the 2005 fee.

The Effect of the Decision

The FTB has until mid-May 2006 to appeal the *Northwest* decision to the California Court of Appeals. The FTB will not issue refunds to Northwest, nor will it process protective claims for refunds filed by other LLCs, unless and until there is a final appellate court decision in favor of Northwest. Nevertheless, because a favorable appellate decision could impact all LLCs that are paying and have paid the fee, you should consult your tax advisor and consider filing protective claims for refund of the fee for all open years.

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