
Becoming One with the Refund: California's LLC Fee Is Ruled Unconstitutional

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A common acquisition strategy these days is to form an acquisition limited liability company (LLC) to acquire a target corporation's assets. For example, in a forward merger of a target into an acquiring corporation, the target liquidates and the acquiring corporation assumes the target's liabilities. If instead the acquiring corporation first forms a single-member LLC, the merger of a target into the single-member LLC results in the LLC (instead of the acquiring corporation) assuming the liabilities of the target.

This structure shields the acquiring corporation from the target liabilities. After all, while the single member LLC is disregarded for tax purposes, it remains separate and distinct for state law purposes. This anthropomorphism resulting from being disregarded for one purpose and not for another allows the acquiring corporation to acquire the target's assets while isolating the target's liabilities. It also means M&A professionals need to know something about partnerships and LLCs, not only federal tax law, but also and state law governing such creatures.

Death, Taxes and Refunds

Given the proverbial certainty of death and taxes, many clients get spiritual satisfaction from the fact that courts frequently rule state and local taxes to be unconstitutional. Clients and practitioners find it especially satisfying when they learn that the tax that has been struck down as unconstitutional is a tax they have paid. Hot off the presses is news that a California Superior Court has ruled California's annual fee on LLCs to be unconstitutional. [*Northwest Energetic Services, LLC v. California Franchise Tax Board*, CGC-05-437721 (SF Sup. Ct. Mar. 3, 2006).]

This is Not Your Grandfather's Minimum Tax

California imposes an annual "fee" on LLCs doing business in California, or registered with the California Secretary of State. [Cal. Rev. & Tax. Code §17942.] This is not the standard \$800 minimum franchise tax. Like most businesses, LLCs are required to pay the standard California \$800 minimum franchise tax. [Cal. Rev. & Tax. Code §17941.]

However, in addition to the minimum franchise tax, LLCs must pay an annual "fee." California calculates the LLC annual fee based on the LLC's worldwide gross income. Under the newly invalidated statute, it is immaterial whether the LLC earns any portion of its income in California. The LLC still pays the annual fee in full. The LLC annual fee is determined as follows:

- If the LLC's total income is between \$250,000 and \$500,000, the fee is \$900.
- If the LLC's total income is between \$500,000 and \$1,000,000, the fee is \$2,500.
- If the LLC's total income is between \$1 million and \$5 million, the fee is \$6,000.
- If the LLC's total income is more than \$5 million, the tax is \$11,790.

A Tax by Any Other Name

Having annual sales in excess of \$5 million is not difficult for an LLC. Thus, many LLCs doing business in the state (and many not doing business in the state, but registered with the state and subject to the fee) are paying the \$11,790 fee each year. In *Northwest Energetic*, the plaintiff was in fact a Washington State LLC registered in California, but not doing business in the state.

The court in *Northwest Energetic* held that the LLC annual "fee" is really a tax, ignoring the label placed on the tax by the state. Moreover, the court determined that although the fee was a tax, the State did not apportion the LLC annual tax. Apportionment is required for taxes imposed on taxpayers doing business both inside the state and outside the state, based on a taxpayer's business activities within and without the state. [See *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977).] Since the tax is not calibrated based on the business' California business activity or operations, the court ruled that the tax violated the Federal Commerce Clause and was unconstitutional.

Did Somebody Say "Refund"?

No doubt the California Franchise Tax Board ("FTB") will appeal the decision. What choice do they have? There is a great deal of money at stake, and California desperately needs it. After all, the state has realized budget shortfalls in recent years. Thus, it is unlikely the state will issue any tax (or fee) refunds while an appeal is pending.

Moreover, the FTB will likely require LLCs to continue paying the tax during the appeal. However, LLCs that have paid the tax may consider filing protective claims for refund for any open refund years. California has a four-year statute of limitations on audit and refund. [Cal. Rev. & Tax. Code §19306.] The statute of limitations for refunds begins on the later of April 15 or the filing of the LLC's state tax return. [*Id.*] Thus, the LLCs may file protective claims for refund for tax year 2001, depending on when the LLC's return was filed in 2002. Therefore, time may be of the essence.

LLCs may also file protective claims for refund for tax years 2002 through 2005. An LLC paying the \$11,790 minimum tax could file protective claims for a total of five years (2001 through 2005), totaling approximately \$59,000. Claims for refund accrue interest. Interest adds up pretty quick and can double the amount of a refund in no time. As *Northwest Energetic* continues to work its way through a series of appeals, LLCs may continue to file protective claims each time the LLC annual fee is paid (for example, in connection with annual fee paid for tax year 2006).

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Pretty Soon, You're Talking Real Money

Thus, although the potential refund in the case of many LLCs may not exceed the \$59,000 amount (before interest), it may still be nothing to sneeze at. Moreover, many businesses are operated through multiple

LLCs representing, for example, different lines of business operations. In such case, the potential refund may be larger. However, whether the protective claim is large or small it is an opportunity that probably should not be overlooked.