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June 10, 2008



The California LLC Fee: One Small Victory for Out-of-State LLCs

[Scott B. Johnson](#)

Earlier this year, a California appellate court ruled in *Northwest Energetic Services v. Franchise Tax Board*, that California's annual limited liability company (LLC) fee, as applied to an out-of-state LLC in years prior to 2007, is unconstitutional. The California Franchise Tax Board has indicated it will not challenge the ruling, and is now in the process of reviewing and acting upon refund claims received from similarly situated LLCs.

By way of background, an LLC that has filed articles of organization with the California Secretary of State, has been issued a certificate of registration by the California Secretary of State, or is doing business in California, must pay to the State of California an annual \$800 franchise tax and, if the LLC's income equals or exceeds \$250,000, an annual LLC fee. The annual LLC fee ranges from \$900 to \$11,790. For tax years prior to 2007, the fee was based on total income from all sources *reportable to California* (i.e., worldwide income). Legislation enacted in October 2007 changed the basis for the fee, such that for tax years beginning in or after 2007, the fee is based on total income from all sources *derived from or attributable to California*.

In the *Northwest* case, the appellate court ruled that the annual fee as determined for years prior to 2007, is unconstitutional as applied to an out-of-state LLC that had been issued a certificate of registration by the California Secretary of State, but had conducted no business in California. The LLC under consideration was organized under the laws of the State of Washington, with business locations in Washington and Oregon. It engaged in the business of distributing products and related services to customers in Washington, Montana, Oregon, and Idaho. The LLC had no

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operations, property, inventory, employees, agents, independent contractors or place of business in California. Nor did it solicit customers in California or make any deliveries to customers in California. The LLC nonetheless registered with the California Secretary of State. (It is not clear *why* the LLC registered with the California Secretary of State.) The appellate court concluded that the fee was unconstitutional as applied to the LLC because the fee was calculated by reference to the total income of an LLC that conducted no business in California.

The *Northwest* case does not address the circumstances in which an LLC earns income from activities only in California or earns income from activities both within and without California.

Following the appellate court's decision in the *Northwest* case, the California Franchise Tax Board issued Notice 2008-2, to inform LLCs that have filed refund claims that additional information is required to determine if their circumstances are identical to those involved in the *Northwest* case, so that their refund claims may be acted upon. In addition, Notice 2008-2 informs LLCs that operate in a manner similar to the LLC in *Northwest* and now wish to file claims (if the statute of limitations remains open), of the information that should be included with the claim in order for it to be promptly processed.

Currently, California courts are considering whether the LLC fee is constitutional as applied to LLCs that earn income from activities only in California or from activities both within and without California

Apart from pending court cases, legislative developments may also affect the LLC fee. In recent legislative sessions, it was proposed that the LLC fee be paid on an estimated basis during the sixth month of the taxable year rather than after year end, and that a 50% penalty be imposed if the fee is underpaid. This proposal was withdrawn earlier this year.

FOR ADDITIONAL INFORMATION ON THIS ISSUE, CONTACT:



[Scott B. Johnson](#) Mr. Johnson advises and assists clients with respect to the legal aspects of their business matters, including the formation, acquisition, operation and disposition of sole proprietorships, joint ventures, partnerships, limited liability companies and corporations, and the preparation of entity governance documentation as well as transactional, commercial and employment contracts

Partner
dmeaders@manatt.com
 310.312.4345

Donald J. Fitzgerald
 Partner
dfitzgerald@manatt.com
 650.812.1309

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