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California Legislature Passes Bill Applying Retroactive LLC Fee Formula

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On March 24, 2006, we posted a client alert detailing the California Franchise Tax Board's published procedures for taxpayers wishing to file protective claims in response to *Northwest Energetic Services, LLC v. California Franchise Tax Board*, which held that the LLC fee codified at Cal. Rev. & Tax. Code § 17942 was an unconstitutional unapportioned "tax" rather than a fee or levy.^[1] While that case is still pending in the California Court of Appeal, the state legislature has taken action to amend the LLC fee provisions and limit existing and potential refund claims.

On October 10, 2007, the California Governor signed into law AB 198, amending Cal. Rev. & Tax. Code § 17942. Without admitting that the current LLC fee is unconstitutional, the amendments attempt to remedy the infirmities found by the court in *Northwest Energetic* and *Ventas Finance I, LLC v. Franchise Tax Board* by amending Cal. Rev. & Tax. Code § 17942 to require apportioning the LLC's total income to California. However, rather than using an apportionment formula similar to that used for the corporate franchise tax, AB 198 essentially applies a gross receipts tax based on total gross receipts from sales in California. Thus, it determines the LLC fee based on the total income of the LLC (defined as gross income plus cost of goods sold) assigned to California pursuant to the franchise tax rules for computing the numerator of the sales factor.

Notably, AB 198 also limits the amounts of refunds that may be paid on all pending and subsequently filed claims for refund of the LLC fee. AB 198 limits such claims to the amount that the taxpayer's payment exceeds the amount that would have been due under the new rules. This retroactive application of the law will likely be subject to taxpayer challenge, however, given the decision in *City of Modesto v. National Med, Inc.* ("NMI"). In *NMI*, the Court of Appeal ruled that the Due Process Clause prohibited the City's attempt to apply a retroactive apportionment scheme to a previously unapportioned municipal business license tax because forcing a taxpayer to prove which of its gross receipts from several years earlier were earned inside and outside the City denied the taxpayer a "clear and certain remedy" and placed an unfair burden on the taxpayer to correct the City's error in originally drafting an unapportioned tax.^[2] This challenge to the retroactive application of AB 198 is one of a number of grounds that may be raised in possible challenges to the legislation.

[1] See <http://www.mofo.com/news/updates/files/update02167.html>.

[2] A more complete analysis of the *NMI* decision's application to the retroactive LLC fee may be found at <http://www.mofo.com/news/updates/files/8917.html>.