State Law & State Taxation Corner

By John A. Biek

Some States Push the Constitutional Envelope with Unapportioned Taxes on LLCs and LLPs

Introduction

As states have faced budget crises, limited liability companies ("LLCs") and limited liability partnerships ("LLPs") have proven to be a popular source of new revenue. Most states do not impose an entity level income tax on LLCs and LLPs, of course, but many states have imposed (or increased) annual filing fees or taxes on these passthrough entities, based on a variety of measures, *e.g.*, their net income, gross receipts, capital or even the number of their partners or members.[1] There is nothing wrong with a state making an LLC or LLP doing business in the state pay for the cost of its regulation or even produce tax revenue for the states. Like other state taxes, however, these passthrough entity taxes must satisfy the constraints of the Due Process Clause and the Commerce Clause of the United States Constitution.

California learned this lesson to its dismay, as its unapportioned tax on the "total income from all sources" of LLCs was found to be unconstitutional in the *Northwest Energetic Services*[2] and *Ventas Finance*[3] cases discussed in this article. The California Franchise Tax Board has appealed the trial court decisions in these two cases, but in the meantime the California legislature has had to deal with the unwelcome news that the state ultimately could be required to pay more than $1.3 billion of refunds to LLCs that have paid the unconstitutional tax. In October 2007, California finally enacted legislation that adds an apportionment mechanism to its annual LLC tax and attempts to minimize the amount of refunds that California may be required to pay for its past discrimination by retroactively applying the

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apportionment mechanism to LLC tax assessments and protective refund claims that are not yet final.[4] Because the annual California LLC tax caps out at $11,790, many California-based LLCs probably would owe the maximum LLC tax on their California-source income. However, the California appellate courts, not the California legislature, will determine the remedy for the unapportioned LLC tax that the state applied during past years, so California is not out of the woods yet on this constitutional issue.

The holdings of the *Northwest Energetic Services* and *Ventas Finance* cases raise questions about the constitutionality of several other unapportioned state taxes or annual "filing fees" on passthrough entities. For example, New Jersey, Delaware and New York have statutes requiring LLCs and/or LLPs doing business in the state to pay an annual fee per member or partner, *regardless of where the member or partner is located,* and the New Jersey and Delaware annual fees can add up to $250,000 and $120,00, respectively.[5] The New Jersey Division of Taxation has used its regulatory powers to add an apportionment mechanism to the New Jersey passthrough entity filing fee, but Delaware and New York are still requiring LLCs and LLPs to pay the annual filing fee with respect to out-of-state partners. These two states are extracting a substantial, and quite possibly unconstitutional, tax on professional services partnerships and investment partnerships on LLCs or LLPs that have a large number of members or partners *operating outside the state*.

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The Constitutional Requirement of a Fairly Apportioned State Tax

One of the fundamental principles of state taxation is that a multistate business cannot be required to pay tax to a state on income or receipts arising outside the state's borders. If this were not the rule, a multistate business could be required to pay an aggregate state tax liability that far exceeds the tax liability that a comparable intrastate business would owe to the single state where it does business. The U.S. Supreme Court has long recognized that such onerous state taxation of interstate commerce would result in extraterritorial taxation and undermine the national economy.

Thus, the Supreme Court has held that the Due Process Clause of the United States Constitution prohibits state taxes that do not have "some minimum connection between [the] state and the person, property or transaction it seeks to tax."[6] The Due Process Clause also requires that the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing State."[7]

As for the Commerce Clause, the Supreme Court held in *Complete Auto Transit, Inc. v. Brady*[8] that a state tax must satisfy the following four criteria to ensure that the state tax is not unduly burdening interstate commerce: (1) the tax must be applied to an activity that has a "substantial nexus" with the taxing state; (2) the tax must be fairly apportioned to activities carried on by the taxpayer in the taxing state; (3) the tax cannot discriminate against interstate commerce; and (4) the amount of the tax must be fairly related to services provided by the state to the taxpayer.[9]

This article is concerned with the second prong of the *Complete Auto Transit* test—the requirement that the state tax must be "fairly apportioned" in order for the tax to pass muster under the Commerce Clause. This constitutional requirement seeks to prevent states from taxing businesses engaged in interstate commerce more heavily than their own intra-state businesses. State income taxes and franchise taxes typically satisfy the fair apportionment requirement of the Commerce Clause by utilizing formulary apportionment to divide the net income or capital of a multistate business among the taxing state and the other states where the business is operating. State sales and use taxes usually comply with the fair apportionment requirement by providing the taxpayer a credit for sales or use taxes that it has paid to other states on the tangible personal property (or taxable services) that the taxpayer is bringing into the taxing state for use, storage or consumption in that state.

In its *Container Corporation* decision,[10] the Supreme Court refined the fair apportionment requirement by articulating the "internal consistency" and "external consistency" tests to determine whether an apportionment method is constitutionally "fair." The *Container Corp.* case involved a Commerce Clause challenge to California's application of its corporation franchise tax to the apportioned worldwide income of unitary businesses, computed with apportionment factors whose denominators included the worldwide property, payroll and sales of the unitary business. In considering whether California's worldwide unitary taxation method was constitutional, the Supreme Court observed that:

> Such an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. [citations omitted.] The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.[11]

Although the Supreme Court did not actually apply the internal consistency and external consistency tests in its opinion, the California apportionment formula clearly satisfied the internal consistency test because if every state and foreign jurisdiction where Container Corporation was doing business were to utilize the California apportionment formula, no more than 100 percent of Container Corporation's worldwide income would be subject to taxation. It appears that the Supreme Court concluded that the court described the three-factor California apportionment formula as being "something of a benchmark against which other apportionment formulas are judged" because the three factors reflected the roles that a company's capital (the property factor), labor force (the payroll factor) and customer base (the sales factor) play in producing the company's income.[12]

In *American Trucking Association, Inc. v. Scheiner*,[13] the Supreme Court struck down Pennsylvania's annual flat taxes on trucks operating over the roads of Pennsylvania because the Supreme Court found that these unapportioned taxes violated the internal consistency test of the Commerce Clause. Pennsylvania imposed an annual axle tax that ranged from $72 to $180 per truck, as well as a $25 identification marker fee, on all trucks traveling on Pennsylvania roads, in addition to the annual registration fee that all states imposed on the trucking industry. The Supreme Court concluded in the *American Trucking Association* case that the annual Pennsylvania registration fee satisfied the internal consistency test because, like other states, Pennsylvania exempted trucks that were registered in other states (and had paid an annual registration fee to that home state) from having to pay the Pennsylvania annual registration fee to travel on Pennsylvania roads.[14] This reciprocity arrangement resulted in trucks operating in interstate commerce paying the annual registration fee only to their home states.

The Supreme Court went on to determine, however, that the *unapportioned* Pennsylvania axle tax and marker fee failed the internal consistency test because Pennsylvania provided no reciprocity or exemption for interstate trucks that had paid similar taxes to other states. Because the Pennsylvania axle tax and marker fee were not calibrated to, for example, on the percentage of its miles that a truck traveled on Pennsylvania roads, the Supreme Court concluded in *American Trucking Association* that "[i]f each state imposed flat taxes for the privilege of making commercial entrances into its territory, there is no conceivable doubt that commerce among the states would be deterred."[15]

It is important to bear in mind that a taxpayer bringing an internal consistency test challenge is *not* required to show that other states are actually imposing similar taxes that, when combined with the challenged state tax, result in more than 100-percent taxation of the taxpayer. Instead, the court inquires whether, if every state were hypothetically to impose a similar tax, more than 100 percent of the tax base would be subject to state taxation.

This does not mean that state taxes on an interstate activity must utilize formulary apportionment in order to satisfy the internal and external consistency tests. For example, in *Goldberg v. Sweet*[16] and *Oklahoma Tax Commission v. Jefferson Lines, Inc.*,[17] the Supreme Court found that state excise taxes on interstate telecommunications services and bus services satisfied the internal and external consistency tests, even though the excise taxes were not apportioned with a mileage ratio, because Illinois only imposed its tax on interstate telecommunications services that originated or terminated in Illinois *and* were purchased or billed to an address in the state, while Oklahoma only taxed bus tickets sold in Oklahoma for travel originating in the state.[18]

Because the risk of multiple state taxation was low (in the case of the Illinois telecommunications excise tax) or nonexistent (in the case of the Oklahoma bus ticket tax) if every state were to apply the same rules, the Supreme Court concluded that the Illinois and Oklahoma excise taxes satisfied the internal consistency test. The Supreme Court also agreed with the argument that, as a practical matter, the state was only taxing activity taking place within its borders, thereby satisfying the external consistency test.

The *Northwest Energetic Services* and *Ventas Finance* Cases

The case of *Northwest Energetic Services, LLC v. California Franchise Tax Board*[19] involved a Washington State LLC that was engaged in the business of distributing explosives and explosive-related services *outside California*.[20] According to the stipulation of facts that Northwest Energetic Services, LLC ("NES") and the California Franchise Tax Board (the "FTB") entered into, NES maintained offices in Washington State and Oregon and conducted all of its business operations *outside California*.[21] The parties further stipulated that NES had no business operations, property, inventory or place of business, employee, agent or independent contractor acting on its behalf in California. In fact, NES did not even solicit sales from, or make deliveries to, customers located in California because the state was not part of NES's distribution territory.[22] Nevertheless, NES decided to register with the California Secretary of State to do business in California during the calendar years 1997 and 1999 through 2001.

This qualification of NES to do business in California pursuant to Section 17451 of the California Corporations Code subjected NES to the annual $800 minimum tax imposed by California Revenue and Taxation Code Section 17941 on domestic or foreign LLCs that are "doing business," or are organized or qualified to do business in California. The qualification of NES to do business in California also required the LLC to pay the annual LLC fee (the "Levy") provided for in California Revenue and Taxation Code Section 17942(a), as follows:

> In addition to the tax imposed under Section 17941, every limited liability company subject to tax under Section 17941 shall pay annually to this state a fee equal to:
>
> (1) Nine hundred dollars ($900), if the *total income from all sources* reportable to this state for the taxable year is two hundred fifty thousand dollars ($250,000) or more, but less than five hundred thousand dollars ($500,000).
>
> (2) Two thousand five hundred dollars ($2,500), if the *total income from all sources* reportable to this state for the taxable year is five hundred thousand dollars ($500,000) or more, but less than one million dollars ($1,000,000).
>
> (3) Six thousand dollars ($6,000), if the *total income from all sources* reportable to this state for the taxable year is one million dollars ($1,000,000) or more, but less than five million dollars ($5,000,000).
>
> (4) Eleven thousand seven hundred ninety dollars ($11,790), if the *total income from all sources* reportable to this state for the taxable year is five million dollars ($5,000,000) or more.[23]

Section 17942(b)(1) provided that "[f]or purposes of this section, 'total income' means gross income, as defined in Section 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer." Conspicuously absent from this definition of "total income" was any allocation or apportionment mechanism to calibrate the amount of the annual Levy to the amount of gross income that the domestic or foreign LLC was deriving from sources in California.

NES and the FTB agreed that the Levy imposed by Section 17942(a) was computed on an LLC's "total income from all sources," wherever earned.[24] Judge Donald Mitchell of the California Superior Court for the County of San Francisco observed in his *Northwest Energetic Services* opinion that "[d]ue to this absence of any apportionment mechanism for the Levy, any LLC earning the same amount of total income as Plaintiff earned annually would pay the same Levy as Plaintiff, even if it conducted all of its activity in California."[25]

NES paid the $27,458.13 of Levy, penalties and interest that it owed to California for the 1997 and 1999-2001 tax years pursuant to Section 17942 and then filed a refund claim with the FTB to recover its payment, arguing that the Levy was an unapportioned tax that violated the Due Process Clause and Commerce Clause of the U.S. Constitution.[26]

The FTB responded that the Levy was an annual fee, rather than a tax that needed to comply with the "fair apportionment" requirement of the *Complete Auto Transit* case.

Judge Mitchell determined, as a preliminary matter, that even though NES had brought the refund claim, "'the government bears the burden of proof' that the true substance of a levy is a fee and not a tax under California law."[27] Judge Mitchell then observed that:

> The essence of a tax is that it raises revenue for general governmental purposes and is "compulsory rather than imposed in response to a voluntary decision . . . to seek benefits." *Sinclair Paint Co. v. State Bd. Of Equaliz.* 15 Cal. 4th 866, 874 (1997). A fee, by contrast, must fund a regulatory program or compensate for services provided by, and/or benefits received from, the government. *Id.* at 874-75 (describing three types of fees—regulatory fees, development fees, and special assessments).[28]

Turning to the legislative history of the Levy,[29] Judge Mitchell determined that the Levy and the $800 minimum tax had been enacted in 1994 as part of the California Limited Liability Company Act[30] to help offset the loss of income tax and franchise tax revenue that the FTB expected to result from California treating an LLC as a passthrough entity rather than taxing the LLC on its income like a C corporation.[31]

The FTB had argued that the Levy was merely an annual regulatory fee imposed to fund the cost of the California Secretary of State's administration and enforcement of the state's LLC laws. Drawing on this legislative history, Judge Mitchell found, however, that:

> [T]he Levy is clearly a tax. As noted above, the record in this case confirms the purpose of the Levy is to raise revenue. *See* discussion at pp. 2-4, *supra*. Moreover, unlike the revenues from a fee, which must be dedicated to its purpose, *e.g.*, the regulatory scheme it is intended to fund, the Levy is intended for, and used solely for, general governmental purposes. (JS ¶18.) *See* discussion at p. 4, *supra*. In light of the revenue raising purpose and the deposit of the proceeds into the general fund for general governmental purposes, the Levy is a tax.[32]

> It is important to bear in mind that a taxpayer bringing an internal consistency test challenge is *not* required to show that other states are actually imposing similar taxes . . .

Judge Mitchell also rejected the FTB's characterization of the Levy as a regulatory fee, because the FTB had not shown that the amounts raised by the Levy was commensurate with the costs of the California Secretary of State's regulatory activities:

> The FTB identifies the relevant costs as "those incident to the issuance of the license or permit, investigation, inspection, administration, maintenance of a system of supervision and enforcement." But the FTB never attempted to quantify these costs. Indeed, the FTB has introduced no evidence that the Levy is related in any way to regulating LLCs, or that its proceeds fund any regulatory program or otherwise compensate for services provided by, and/or benefits received from, the government. The FTB's unsubstantiated claims that the benefits enjoyed by LLCs are "highly valuable," "immeasurable," and "clearly exceed the minimal amount of the annual LLC fee" do not satisfy the FTB's burden.[33]

Indeed, the fact that NES did no business in California belied FTB's contention that NES was receiving services or benefits from California that should be compensated and paid for with the Levy that the FTB was imposed on NES.[34]

Having determined that the Levy was a tax, Judge Mitchell was almost compelled to conclude that the unapportioned Levy failed the fair apportionment requirement of the Commerce Clause. As Judge Mitchell explained:

> Applying the internal consistency requirement, if one assumes that the Levy were replicated in every state across the country, an interstate LLC with the same total income as Plaintiff would pay the maximum Levy in every jurisdiction in which it operated (or simply registered to do business). By contrast, an LLC operating wholly

within a single state would pay the maximum Levy, but only once. Thus, interstate commerce plainly would bear a greater burden than intrastate commerce, and the Levy fails the internal consistency test. Moreover, as demonstrated by Plaintiff's alleged liability for the Levy despite its lack of any activity in California, the Levy undeniably "reaches beyond the portion of value that is fairly attributable to economic activity within the taxing State." Stated differently, it is clear the Levy is not calibrated to Plaintiff's California activity because Plaintiff engaged in none. Therefore, the Levy also fails the external consistency requirement.[35]

Citing the Supreme Court's *American Trucking Association* decision, Judge Mitchell concluded that the unapportioned Levy was unconstitutional regardless of whether the Levy was viewed as a tax or a fee.[36] As a result, the Superior Court granted NES a full refund of its Levy payment.[37]

In the meantime, the *Northwest Energetic Services* and *Ventas Finance* decisions have produced an avalanche of protective refund claims from domestic and foreign LLCs seeking to recover the unapportioned Levy payments that they have remitted to California.

In November 2006, Judge Paul Alvarado of the California Superior Court for the County of San Francisco issued a similar decision in *Ventas Finance I, LLC v. California Franchise Tax Board.*[38] However, the *Ventas Finance* opinion went further than the *Northwest Energetic Services* opinion had by determining that Section 17942 could not be reformed by the court to make the statute constitutional because:

> [a]dding an apportionment mechanism as [the FTB] suggests would run contra to the Legislature's expressed intent. The legislative history establishes that the Legislature considered and rejected apportionment of the Levy. . . . Neither the statue nor the legislative history contains any indication of the type of apportionment scheme the Legislature would have enacted.[39]

Consequently, Judge Alvarado struck down the Levy as an unapportioned tax and ordered a full refund of the Levy payments, plus interest and costs, that Ventas Finance had paid to the FTB.[40]

The Aftermath of the *Northwest Energetic Services* and *Ventas Finance* Cases

The FTB has appealed the Superior Court decisions in *Northwest Energetic Services* and *Ventas Finance* cases, but appellate court rulings are not expected until some time later this year.[41] The thrust of the FTB's appeal, presumably, is that the Section 17942 Levy is a regulatory fee that does not have to meet the fair apportionment requirement of the Commerce Clause, but the plaintiffs are certainly going to point to Judge Mitchell's observation in *Northwest Energetic Services* that the Supreme Court's *American Trucking Association* opinion applied the fair apportionment requirement and internal consistency test to regulatory fees as well as to taxes. Thus, the FTB appears to have an uphill battle on its hands defending the constitutionality of the unapportioned Section 17942 Levy.

In the meantime, the *Northwest Energetic Services* and *Ventas Finance* decisions have produced an avalanche of protective refund claims from domestic and foreign LLCs seeking to recover the unapportioned Levy payments that they have remitted to California. As of October 2007, approximately 86,000 LLCs had filed protective refund claims totaling $450 million, with the FTB. According to some observers, these refund claims could ultimately amount to $1.3 billion.[42] For a state already in fiscal peril, this was most distressing news.

California suffered another fiscal blow in April 2007, when a group of LLCs doing business entirely in California filed a third lawsuit challenging the constitutionally of the Section 17942 Levy in *Bakersfield Mall LLC v. California Franchise Tax Board.*[43] The plaintiff LLCs in the *Bakersfield Mall* case are seeking class certification to recover refunds of Levy payments made by all LLCs that derive income solely within California. The *Bakersfield Mall* plaintiffs are at the other end of the spectrum from Northwest Energetic Services LLC, the original challenger of the Section 17942 Levy, which *does no business in California,* but a facially discriminatory state tax cannot be applied against any taxpayer, even an intrastate taxpayer. Moreover, Judge Alvardo concluded in *Ventas Finance* that the Section 17942 Levy cannot be reformed by the courts to make it constitutional.

Facing a bad situation, the California General Assembly finally amended Section 17942 on September 12, 2007 to make the Levy constitutional. California A.B. 198 amended Section 17942(a)(1)-(4), for tax years beginning on or after January 1, 2007, to make the tax base *"total income from all sources derived from or attributable to this state."*[44] According to the new Section 17942(b)(1)(B), an LLC's total income tax base now will be apportioned within and without California using the California corporation franchise tax allocation and apportionment rules of Section 25135 and 25136 and the regulations thereunder, as modified by regulations under Section 25137 (other than the provisions excluding certain receipts from the sales factor). This new apportionment mechanism is expected to clear up the constitutional problem with the Section 17942 Levy going forward.

However, the California legislature also included a "no harm, no foul" provision in A.B. 198 that attempts to limit the amount of refund payments that the state is required to issue for the *unapportioned* Section 17942 Levy for pre-2007 tax periods. Specifically, Section 3 of A.B. 198 adds a new Section 19394 of the Revenue and Taxation Code stating that "[i]f the fee provided under Section 17942 is finally adjudged to be discriminatory or unfairly apportioned under the California Constitution, or the laws or the Constitution of the United States, the fee of a disfavored taxpayer that files, or has filed, a timely claim for refund within the period allowed by this part . . . shall be recomputed by the Franchise Tax Board . . . only to the extent necessary to remedy the discrimination or unfair apportionment . . . ." This new Section 19394 will apply to suits for refunds that are filed on or after, or were not yet final as of the October 10, 2007 enactment date of A.B. 198.

Section 4(d) of A.B. 198 further provides that:

> Refunds of fees payable as a result of the litigation described in subdivision (a) [*i.e.*, the *Northwest Energetic Services, Ventas Finance* and *Bakersfield Mall* cases] shall be limited to the amount by which the fee paid, and any interest assessed thereon, exceeds the amount that would have been assessed if the fee had been computed in accordance with subparagraph (B) of paragraph (1) of subdivision (b) of Section 17942 of the Revenue and Taxation Code, as added by the amendments to that section made by Section 2 of this act."[45]

The FTB reportedly plans to rely on this uncodified remedy provision to limit refunds for all LLCs, including the plaintiffs in the pending *Northwest Energetic Services*, *Ventas Finance* and *Bakersfield Mall* cases, to the excess amount of the LLC's Levy payment over the amount of Levy that the LLC would have paid to California if the apportionment mechanism had been included in Section 17942 during the refund period at issue. Because more than 90 percent of the LLCs registered in California either do business entirely in California or have annual California–source income that exceeds the $5 million threshold necessary to subject the LLC to the maximum $11,790 Levy amount, the California legislative staff anticipates that most LLCs will not be eligible for any refund of their pre-2007 Levy payments because of the "no harm, no foul" refund remedy included in the recently enacted A.B. 198. [46]

The New Jersey Passthrough Entity "Filing Fee"

New Jersey is one of several states that, while they follow the federal income tax classification of general and limited partnerships, LLCs and LLPs as passthrough entities, they extract significant revenue by charging the passthrough entity an annual "filing fee" measured by the number of partners or members in the passthrough entity. Section 54A:8-6(b)(2)(A) of the New Jersey Revised Statutes provides that:

> Each entity classified as a partnership for federal income tax purposes, other than an investment club, *having any income derived from New Jersey sources*, including but not limited to a partnership, a limited liability partnership, or a limited liability company, *that has more than two owners shall* at the prescribed time for making the return required under this subsection *make a payment of a filing fee of $150 for each owner of an interest in the entity,* up to a maximum of $250,000.[47]

Significantly, there is no provision in Section 54A:8-6(b)(2) that would limit or otherwise calibrate the amount of the filing fee to the number of partners or members in the passthrough entity who are residents of, or operating in, New Jersey.

Although Section 54A:8-6(b)(2)(A) describes the partnership payment as a "filing fee," it is noteworthy that no fee is due unless the partnership earns income from New Jersey sources.[48] Section 54A:8-6(b)(2)(C) also provides that the partnership filing fee "shall, for purposes of administration, be payments to which the provisions of the State Uniform Tax Procedure Law, R.S. 54:28-1 *et seq.* shall be applicable and the collection thereof may be enforced by the director in the manner provided therein."

Therefore, the New Jersey passthrough entity filing fee bears more than a little resemblance to a tax. Indeed, a filing fee of $150 per partner, regardless of his location, is likely to raise a substantial amount of revenue for New Jersey, particularly from professional services partnerships and investment partnerships with a large number of partners, who may or may not be located in New Jersey. Indeed, the New Jersey legislature appears to have planned to raise substantial revenue for the state by setting the maximum New Jersey passthrough entity filing fee amount at a hefty $250,000. Moreover, tiered partnerships are required to pay the New Jersey passthrough entity filing fee *at each level of the partnership structure* because the upper tier partnership is considered to be deriving New Jersey source income through the business activities of the lower-tier partnership operating in New Jersey.[49] Consequently, it appears likely that some partnerships, LLC and LLPs will be subject to an annual New Jersey filing fee that far exceeds the state's actual cost of regulating these passthrough entities, lending support for the conclusion that the annual filing fee is really a revenue raising tax that must be fairly apportioned if it is to be constitutional.

> The *Northwest Energetic Services* and *Ventas Finance* cases provide a useful reminder that states that classify partnerships, LLCs and LLPs as "passthrough entities" for state income/franchise tax purposes may still impose heavy annual filing fees . . .

It appears that the New Jersey Division of Taxation recognized this constitutional shortcoming in Section 54A:8-6(b)(2) because the Division has promulgated a regulation that apportions the annual filing fee imposed with respect to partners or members who are not physically present in New Jersey. Specifically, New Jersey Regulation 18:35-11.2(b) provides that "[i]f a partnership includes non-resident partners, some of whom have physical nexus with New Jersey and some of whom do not, then an apportionment methodology for the partnership filing fee may be used, provided the partnership has an office outside New Jersey." Regulation 18:35-11.2(c) requires that the partnership pay an annual filing fee of $150 for each resident partner and each nonresident partner who has some physical nexus in New Jersey. However, the filing fee due with respect to nonresident partners *without any physical nexus in New Jersey* can be determined by multiplying the $150 fee by the three-factor apportionment factor of the partnership.[50]

The Division's regulations offer an example in which a Connecticut partnership with offices in New Haven and New Jersey sells small tables. Ten partners reside in New Jersey and ten partners reside in Connecticut. Four of the ten Connecticut-resident partners work entirely outside New Jersey, while the other six Connecticut-resident partners work at the partnership's New Jersey office. New Jersey customers of the business purchase $200,000 worth of tables per year, and the partnership's New Jersey allocation factor is 40 percent. Based on these facts, the regulation explains that the partnership owes an annual New Jersey filing fee of $2,640 computed as follows: ten New Jersey resident partners x $150, plus six Connecticut resident partners with physical nexus in New Jersey x $150, plus four Connecticut resident partners without physical nexus in New Jersey x $150 x 40 percent.

The New Jersey Partnership Return Voucher (Form Part-100) lays out the apportionment computation for the filing fee for nonresident partners without any physical nexus in New Jersey. It is interesting, however, that New Jersey Regulation 18:35-11.2, on which the form's apportionment schedule is based, will expire on June 20, 2008. Presumably, the Division will reissue this regulation, but if it does not, the apportionment mechanism probably would be deleted from the form because it is not provided for in the New Jersey passthrough entity filing fee statute itself.

The Delaware LLP Filing Fee

Section 15-1207(a)(3) of the Delaware Revised Uniform Partnership Act provides that:

> (a) The following fees shall be paid to and collected by the Secretary of State for the use of the State of Delaware:
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> * * *
>
> (3) Upon the receipt of a statement of qualification, a statement of foreign qualification or an annual report for a limited liability partnership or a foreign limited liability partnership, a fee in the amount of $200 for each partner, but in no event shall the fee payable for any year with respect to a limited partnership or a foreign limited liability partnership under this Section be more than $120,000.[51]

Professional services LLPs and other domestic or foreign LLPs organized or qualified to do business in Delaware could find themselves having to pay the maximum $120,000 fee if the LLP has six hundred partners located anywhere in the world because there is no provision in Section 15-1207 that limits the Delaware LLP fee to partners who reside or have physical presence in Delaware. Nor is the Delaware LLP filing fee calibrated to the amount of income that the LLP earns from sources in Delaware. In fact, an LLP is required to pay the filing fee at the time that the LLP is organized or qualified to do business in Delaware and again with every annual report that the LLP files with the Delaware Secretary of State.

It appears that the Delaware LLP filing fee is designed to raise revenue for the state rather than to cover the actual cost of the Delaware Secretary of State's regulation of LLPs, which has very little to do with the number of partners in the LLP. Moreover, the LLP filing fees are not retained by the Delaware Secretary of State for the use of his office.[52] Accordingly, LLPs with a substantial number of partners could well argue that the Delaware LLP filing fee violates the fair apportionment requirement of the Commerce Clause.

Delaware is kinder to *LLCs* organized or qualified to do business in Delaware, subjecting them to a flat $200 annual tax without regard to the number of members in the LLCs.[53]

The New York LLC/LLP Filing Fee

New York has enacted an annual filing fee for LLCs and LLPs that derive income from New York. Under New York Tax Law Section 658(c)(3):

> Every subchapter K limited liability company, every limited liability company which is a disregarded entity for federal income tax purposes and every limited liability partnership under article eight-B of the partnership law and every foreign limited liability partnership, *which has any income derived from New York sources*, determined in accordance with the applicable rules of section six hundred thirty-one of this article as in the case of a nonresident individual, *shall* within thirty days after the last day of the taxable year, *make a payment of a filing fee. The amount of the filing fee shall be the product of (a) one hundred dollars and (b) the number of members of each company or number of partners of such partnership,* as the case may be, as of the last day of the taxable year, but in no event shall such fee be less than five hundred dollars nor more than twenty-five thousand dollars.[54]

Effective with the 2007 tax year, the temporary New York filing fee amounts cited in this quoted statute expired, and the filing fees reverted back to $50 per member or partner in the LLC or LLP, subject to a minimum and maximum filing fee of $325 and $10,000, respectively.[55]

As is the case with the New Jersey and Delaware statutes filing fees previously discussed, the New York LLC/LLP filing fee statute does not allocate or apportion the fee to take account of nonresident partners who do not have any presence in New York. Moreover, the New York Limited Liability Company/Limited Liability Partnership Filing Fee Form (Form IT-204-LL) does *not* follow the New Jersey Division of Taxation's decision to add an apportionment mechanism to the New Jersey passthrough entity filing fee. Indeed, the instructions to New York Form IT-204-LL explicitly provide that "[t]he total number of members or partners includes *all resident and nonresident* individuals, estates and trusts, and all corporations and partnerships that were members or partners of the [LLC or LLP] entity as of the last day of its tax year.[56] As a result, it appears that the annual New York LLC/

California Appeals Court Affirms LLC Fees Unconstitutional

A California court of appeal has held that the imposition of the former LLC fees against an out-of-state LLC that did no business in California was an unapportioned tax that violated the U.S. Commerce Clause. In addition, the court held that the attorney fees awarded to the taxpayer's attorneys were not limited to the amount specified under the Revenue and Taxation Code (RTC), but that the trial court did not clearly articulate its basis for the enhanced lodestar amount awarded. Thus the issue of the amount of the attorney fees to be awarded was remanded back to the trial court for further consideration.

The former LLC fee schedule at issue in the appeal was imposed against all LLCs organized, registered, or doing business in California, and was based on a percentage of the LLC's worldwide income. [**CCH Note:** The LLC fee statute has since been amended and is now limited to a percentage of the LLC's income attributable to California.]

The appellate court found that the LLC fee was a tax and not a fee. The LLC fee was enacted as part of the LLC Act, which authorized the formation and recognition of LLCs in California. The legislative history indicated that LLC Act was adopted as a means of retaining and attracting businesses and that the fee was enacted to replace the anticipated lost tax revenues that would result from California corporations that reorganized as LLCs.

The former fee violated the Commerce Clause because the fee was not fairly apportioned. As imposed, the fee violated both the internal and external consistency tests established to determine if a tax is fairly apportioned. It violated the internal consistency test because an LLC operating in interstate commerce would be subject to the fee based on its total worldwide income in every state in which it operated or was registered, whereas an LLC operating in only one state would be subject to the fee only once. Therefore, it could not be argued that the fee related strictly to local activities occurring solely within the state. Furthermore, the fee violated the external consistency test because it taxed the LLC's income attributable to economic activity outside the state.

Pike's Balancing Test

Even if the fee was classified as a fee rather than a tax, the fee was unconstitutional under the balancing test articulated by the U.S. Supreme Court in *Pike v. Bruce Church, Inc.*, 397 U.S. 137

LLP filing fee is subject to a potential Commerce Clause challenge.

Conclusion

The *Northwest Energetic Services* and *Ventas Finance* cases provide a useful reminder that states that classify partnerships, LLCs and LLPs as "passthrough entities" for state income/franchise tax purposes may still impose heavy annual filing fees on such business entities to raise revenue for the state. The annual California Levy on LLCs that was addressed in the *Northwest Energetic Services* and *Ventas Finance* cases was clearly imposed on the income of the LLC, and it was equally clear that the Levy was not calibrated to the amount of business that a multistate LLC did in California. When the California Superior Court found that the California Levy was actually a tax, the Superior Court had to conclude that the Levy failed the fair apportionment requirement of the Commerce Clause.

The New Jersey, Delaware and New York annual filing fees on partnerships, LLCs and/or LLPs are a bit more subtle, requiring such a passthrough entity with income from sources in the state (in the case of New Jersey and New York) or business activity in the state (in the case of Delaware) pay an annual filing fee based on the total number of partners or members in the passthrough entity. These "filing fees" can be substantial, capping out at $120,000 for Delaware and $250,000 for New Jersey. It is difficult to conclude that the Delaware, New Jersey and New York filing fees are merely intended to cover the state's cost of regulating these passthrough entities, because the filing fee amounts can be so substantial and the number of partners or members in the passthrough entity should not affect the state's costs of regulating the passthrough entity itself.

The more tenable conclusion is that the annual Delaware, New Jersey and New York filing fees are state

(1970). To pass constitutional muster, (1) the fee must be imposed evenhandedly to effectuate a legitimate local public interest, (2) its effects on interstate commerce must be only incidental, and (3) its burden on interstate commerce must not be clearly excessive in relation to the putative local benefits. The court questioned whether the fee was applied evenhandedly as those LLCs that were doing no business in the state were required to pay for services that they did not receive. The court also ruled that (1) imposition of the fee was more than an incidental burden and (2) the burden on interstate commerce was clearly excessive in relation to the putative local benefits. Because the taxpayer did no business in California, it received no local benefits. Furthermore, as the fees were imposed to combat the loss of revenues from California corporations reorganizing as LLCs and not from foreign LLCs, who were already being taxed as partnerships under FTB policy during the tax years at issue, the court could find no public benefit that was served by subjecting the taxpayer to the fees.

Voluntary Election

The court rejected the FTB's argument that the taxpayer was precluded from raising a Commerce Clause challenge as the taxpayer elected to be taxed as an LLC, and therefore chose to be subject to the fee. The FTB argued that it was the taxpayer's choice to be taxed as an LLC and not the fee itself that placed the burden on interstate commerce. The FTB based this argument on another court's ruling on facts that were clearly distinguishable. That case involved an election regarding the method of state taxation, whereas in the case at hand, the FTB would have the taxpayer give up the advantages of avoiding double taxation on both a state and a federal level. Furthermore, the FTB's reasoning would prevent an unconstitutional tax from ever being challenged as it would preclude all LLCs subject to the fee from bringing a legal challenge.

Refund Remedy

The court noted that the FTB agreed that if the fee was found to be unconstitutional that the taxpayer would be entitled to a full refund of the fee as the taxpayer did no business in California. However, in a footnote, the court noted that "As a general matter, only the portion of the Levy that exceeds Commerce Clause limits must be refunded."

Northwest Energetic Services, LLC v. Franchise Tax Board, California Court of Appeal, First Appellate District, Nos. A114805, A115841, and A115950, January 31, 2008.

taxes on income or business activity of partnerships, LLCs and/or LLPs doing business in the state, bringing the state filing fees squarely within the fair apportionment requirement of the Commerce Clause. The New Jersey Division of Taxation has fixed the constitutional defect in the New Jersey passthrough entity filing fee by adding an apportionment provision to the filing fee. Delaware and New York have not yet taken this step, so their annual filing fees on LLCs and LLPs could be vulnerable to a Commerce Clause challenge.

Endnotes

1 *See* Bruce P. Ely, Christopher R. Grissom and Matthew S. Houser, *State Tax Treatment of Limited Liability Companies and Limited Liability Partnerships*, State Tax Notes 315 (Feb. 5, 2007).

2 *Northwest Energetic Services, LLC v. California Franchise Tax Board*, No. CGC-05-437721 (Cal. Super. Ct. of San Francisco Cty. Apr. 13, 2006), [Cal.] St. Tax Rep (CCH) ¶403-999, *on appeal*, No. A115950 (Cal. Ct. App. Filed Dec. 6, 2006). On January 31, 2008, the California Court of Appeal upheld the finding in *Northwest Energetic Services*.

3 *Ventas Finance I, LLC v. California Franchise Tax Board*, No. CGC-05-440001 (Cal. Super. Ct. of San Francisco Cty. Nov. 7, 2006), [Cal.] St. Tax Rep. (CCH) ¶404-080, *on appeal*, No. A116277 (Cal. Ct. App. Filed Dec. 6, 2006).

4 *See* Cal. A.B. 198 (signed by California Governor on Oct. 10, 2007).

5 N.J. Rev. Stat. §54A: 8-6(b)(2); Del. Code tit. 6, §15-1207; N.Y. Tax Law §658(c)(3).

6 *Miller Brothers Co. v. Maryland*, 347 US 340, 344-45 (1954).

7 *Moorman Mfg. Co. v. Bair*, 437 US 267, 273 (1978); *Wisconsin v. J.C. Penney Co.*, 311 US 435, 444 (1940).

8 *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977).

9 *Id.* at 277-79.

10 *Container Corporation of America v. Franchise Tax Board*, 463 US 159 (1983).

11 *Id.* at 169.

12 *Id.* at 170, 183-84.

13 *American Trucking Association, Inc. v. Scheiner*, 483 US 266 (1987).

14 *Id.* at 283.

15 *Id.* at 284.

16 *Goldberg v. Sweet*, 488 US 252 (1989).

17 *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 US 175 (1995).

18 *Goldberg v. Sweet, 488 US at 589; Jefferson Lines*, 514 US at 185.

19 *Supra* note 2.

20 *Id.* slip op. at 3.

21 *Id.*

ENDNOTES

[22] *Id.*

[23] Cal. Rev. & Tax Code §17942(a) (emphasis added).

[24] *Northwest Energetic Services*, slip op. at 4.

[25] *Id.*

[26] *Id.* slip op. at 3.

[27] *Id.* slip op. at 7 (*quoting from California Ass'n of Professional Scientists v. Department of Fish and Game*, 79 Cal. App. 4th 935, 945 (2000)).

[28] *Northwest Energetic Services*, slip op. at 7.

[29] Cal. S.B. 930 (1994).

[30] Cal. S.B. 469 (1994).

[31] *Northwest Energetic Services*, slip op. at 4.

[32] *Id.* slip op. at 7-8.

[33] *Id.* slip op. at 8.

[34] *Id.* slip op. at 8 n.15.

[35] *Id.* slip op. at 10.

[36] *Id.* slip op. at 11 n.18.

[37] *Id.* slip op. at 11.

[38] *Supra* note 3.

[39] *Id.* slip op. at 3.

[40] *Id.*

[41] *Ventas Finance I, LLC v. California Franchise Tax Board*, No. A116277 (Cal. Ct. App.) and *Northwest Energetic Services LLC v. California Franchise Tax Board*, No. A115950 (Cal. Ct. App. Filed Dec. 6, 2006). Since the writing of this article, the California Court of Appeal, First appellate District, has decided *Northwest Energetic Services, LLC v. Franchise Tax Board*, Nos. A114805, A115841 and A115950, [Cal.] St. Tax Rep (CCH) ¶404-550 (Jan. 31, 2008).

[42] *See* California *Governor Signs Bill to Fix Illegal LLC Fee, Limit Refunds for Most Taxpayers*, DAILY TAX REPORT p. H-4 (Oct. 12, 2007).

[43] *Bakersfield Mall LLC v. California Franchise Tax Board*, No. CGC-462728 (Cal. Super. Ct. of San Francisco Cty., filed on Apr. 25, 2007).

[44] Cal. A.B. 198, §2.

[45] Cal. A.B. 198, §4(d).

[46] *See, California Governor Signs Bill to Fix Illegal LLC Fee, Limit Refunds for Most Taxpayers*, DAILY TAX REPORT p. H-4 (Oct. 12, 2007).

[47] N.J. Rev. Stat. §54A:8-6(b)(2)(A) (emphasis added). An "investment club" is defined in Section 54A:8-6(b)(2) as an entity (a) that is classified as a partnership for federal income tax purposes, (b) that only has individuals as owners, (c) that only has assets comprised of securities, cash and cash equivalents worth, on the last day of the tax year, no more than $250,000 (or $35,000 per owner), adjusted for inflation, and (d) that is not required to be registered with the Securities and Exchange Commission (the "SEC").

[48] N.J. Rev. Stat. §54A:8-6(b)(2)(A); N.J. Reg. 18:35-11.2(a).

[49] *See*, N.J. Reg. 18:35-11.6(a), Example 3; N.J. Division of Taxation, Technical Bulletin TB-55 (Apr. 6, 2005), [N.J.] St. Tax. Rep. (CCH) ¶401-074.

[50] *See also* N.J. Division of Taxation, Technical Bulletin TB-55 (Apr. 6, 2005), [N.J.] St. Tax Rep. (CCH) ¶401-074 ("If a partnership has nonresident partners, the full $150 filing fee is due for each nonresident partner that has physical nexus with New Jersey. If the partnership has income earned outside New Jersey, the filing fee for nonresident partners that do not have physical nexus with New Jersey may be apportioned based on New Jersey source income. (See NJ-1065 for the New Jersey corporate allocation factor to apply for the nonresident partners lacking nexus.)").

[51] Del. Code. tit. 6, §15-1207(a)(3).

[52] *See* Del. Code, tit. 6, §15-1207(a) (the fees provided for in Section 15-1207(a) "shall be paid to and collected by the Secretary of State *for the use of the State of Delaware*") (emphasis added).

[53] Del. Code, tit. 6 §18-1107(b).

[54] N.Y. Tax Law §658(c)(3) (emphasis added).

[55] *See* N.Y. S.B. 3671.

[56] *See* New York Form IT-204-LL Instructions p. 2.