

ENDORSED
FILED
San Francisco County Superior Court

MAR 3 2006

GORDON PARK-LI, Clerk
BY: IRIS L. HAMMER
Deputy Clerk

SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SAN FRANCISCO

NORTHWEST ENERGETIC SERVICES,
LLC, a Washington Limited Liability
Company,

Plaintiff,

v.

CALIFORNIA FRANCHISE TAX
BOARD, an Agency of the State of
California,

Defendant.

No. CGC-05-437721

**PROPOSED STATEMENT OF
DECISION**

Department: 602
Judge: Hon. Donald Mitchell
Hearing Date: January 23, 2006

I. INTRODUCTION

The sole issue in this case is whether California's levy on limited liability companies ("LLCs"), codified as Cal. Rev. & Tax. Code § 17942 (hereinafter the "Levy" or "Section 17942"),¹ violates the Commerce Clause of the United States Constitution or the Due Process Clauses of the United States Constitution. The Court finds that the Levy indeed violates both the Commerce and Due Process Clauses. Accordingly, it cannot be applied to Plaintiff Northwest Energetic

¹ All section references are to the Revenue and Taxation Code unless otherwise noted.

1 Services, LLC (“Plaintiff” or “NES”), and Plaintiff is entitled to a full refund of
2 all amounts it paid (including interest and penalties) pursuant to Section 17942
3 for the calendar years 1997 and 1999 through 2001 (the “Years at Issue”), plus
4 refund interest as provided by law.

5
6 **II. FINDINGS OF FACT**

7 The facts in this case are not in dispute and a stipulation of those facts is
8 attached and incorporated herein.

9 **A. Procedural Background**

10 On June 24, 1997, pursuant to Corporations Code § 17451, Plaintiff
11 registered as an LLC with the Secretary of State and remained registered until
12 June 13, 2002. (Joint Stipulation (“JS”) ¶ 9.) Plaintiff filed tax returns with the
13 FTB for each of the Years at Issue and paid the \$800 minimum tax imposed on
14 LLCs under Rev. & Tax. Code § 17941. (JS ¶ 11.) At the time it filed those
15 returns, Plaintiff did not pay any amounts pursuant to Rev. & Tax. Code § 17942.
16 (JS ¶ 11.)

17 After notification by the FTB of an alleged balance due, Plaintiff paid
18 \$27,458.13 pursuant to Rev. & Tax. Code § 17942 for the Years at Issue
19 (including late payment penalties and interest), and canceled its registration with
20 the California Secretary of State. (JS ¶ 12.) On February 21, 2003, Plaintiff
21 timely filed a claim for refund of the foregoing amount, and thereafter exhausted
22 administrative remedies with respect to the claim. (JS ¶¶ 13-17.)

23 **B. Plaintiff’s Business**

24 During the Years at Issue, NES was an LLC organized under the laws of
25 the State of Washington. (JS ¶ 4.) Plaintiff distributed explosives and
26 explosives-related services to customers located solely outside California.
27 Plaintiff’s only business locations were in Washington and Oregon. (JS ¶ 5.)
28

1 Plaintiff conducted no business activities in California, either transitory or
2 permanent. (JS ¶¶ 6 and 7.) It had no operations, property, inventory, or place
3 of business in California. (*Id.*) Plaintiff had no employees, agents, or
4 independent contractors acting on its behalf in California. (JS ¶ 6.) It made no
5 deliveries to customers in California at any time, nor did it solicit any customers
6 in California because California was not a part of its distribution territory. (JS
7 ¶¶ 4, 6.) Plaintiff's only connection with California during the Years in Issue
8 was that it was registered with the Secretary of State pursuant to Corporations
9 Code § 17451. (JS ¶ 9.)

10 C. The Levy

11 1. Application and Computation of the Levy

12 Section 17942(a) provides that the Levy is applicable to "every limited
13 liability company subject to tax under Section 17941." Under Section 17941,
14 LLCs are subject to tax and, therefore, to the Levy if either (a) they are "doing
15 business" in California, or (b) even if they are not doing business in California,
16 their articles of organization have been accepted by the California Secretary of
17 State or they have received a certificate of registration from the California
18 Secretary of State.

19 Pursuant to Section 17942(a), an LLC's liability for the Levy is computed
20 on the basis of its "total income from all sources reportable in this state for the
21 taxable year."² The parties agree, and this Court finds, that "total income from
22 all sources reportable in this state for the taxable year" means the LLC's "total
23 income," without apportionment. Whereas apportionment would remove from the
24 taxable base income earned outside California's borders, the Levy applies to an
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27 ² Section 17942(b)(1) defines "total income" as "gross income as
28 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." This amount is also
commonly referred to as a taxpayer's "gross receipts."

1 LLC's entire income, wherever earned. Due to this absence of any apportionment
2 mechanism for the Levy, any LLC earning the same amount of total income as
3 Plaintiff earned annually would pay the same Levy as Plaintiff, even if it
4 conducted all of its activity in California.

5
6 **2. Purpose of the Levy and Use of Its Proceeds**

7 The Levy was enacted in 1994 as part of the California Limited Liability
8 Company Act (Senate Bill 469) ("LLC Act"), which authorized LLCs for the first
9 time to organize and register in the State. Because corporations are subject to a
10 franchise tax (based on income) but LLCs are not,³ the Legislature predicted an
11 increasing number of businesses would operate as LLCs rather than as
12 corporations, resulting in a decrease in income tax revenues.⁴ Thus, to offset
13 this loss in tax revenue, the Legislature added to the LLC Act two revenue
14 raising provisions: Section 17942 (which imposed the Levy) and Section 17941
15 (which imposed an \$800 minimum tax).⁵ The law set the Levy for the first few
16 years at graduated amounts that depended upon the range into which the LLC's
17 total income fell.⁶ The law also directed the FTB to analyze annually, beginning
18 in 1999, the revenue impact of the LLC Act, and empowered the FTB to adjust
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21 ³ Unless it elects otherwise, an LLC is not subject to tax by California
22 on its net income. Instead, like a partnership, an LLC is treated as a pass-
through entity, and its owner(s) are taxed on the LLC's income. In contrast,
both corporations and their shareholders are subject to net income tax.

23 ⁴ See FTB Bill Analysis for SB 930 (as introduced), dated August 11,
24 1993, Vol. 6 Joint Exh. 39, JointExh: 1960.

25 ⁵ Senate Revenue and Taxation Committee Revised Bill Analysis for
26 SB 469, Vol. 2 Joint Exh. 18, JointExh: 259; Letter from Sen. R. Beverly to
27 Gov. Wilson, dated August 31, 1994, Vol. 3 Joint Exh. 19, JointExh: 535 (stating
that "[t]he tax provisions have been carefully crafted to ensure the measure is
revenue neutral" by imposing an \$800 minimum tax and the Levy).

28 ⁶ See Stat. 1994, Ch. 1200, § 67 (enacting Cal. Rev. & Tax. Code
§ 23092), Vol. 1 Joint Exh. 9, JointExh: 0264.

1 the amount of the Levy so that the revenue generated by the Levy and the
2 minimum tax equaled the amount of lost corporate income tax revenues.⁷ Based
3 on the record, the Court finds the Levy was designed to replace lost income tax
4 revenue and, therefore, the purpose of the Levy was to raise revenue. This
5 conclusion is bolstered by evidence in the record that all proceeds from the Levy
6 were and are deposited in the State's general fund. (JS ¶ 18.)

7 The Court finds no support for the notion that the purpose of the Levy was
8 to reimburse the State for costs associated with regulating or providing services
9 to LLCs. First, the Legislature specifically provided for appropriations to
10 reimburse the two State agencies (namely, the FTB⁸ and the Secretary of State⁹)
11 that would incur costs to implement the LLC Act.¹⁰

12 Second, to reimburse the one agency that would incur ongoing costs
13 associated with processing LLC filings, the Secretary of State, the Legislature
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15 ⁷ *Id.* (enacting Cal. Rev. & Tax. Code § 23093), Vol 1 Joint Exh. 9,
16 JointExh: 0265.

17 ⁸ *See* Stat. 1994, Ch. 1200 § 94, Vol. 1 Joint Exh. 9, JointExh: 0276
18 (“For purposes of implementing and administering this act in the 1994-95 fiscal
19 year, the sum of three hundred fifty thousand dollars (\$350,000) is hereby
20 appropriated from the General Fund to the Franchise Tax Board, in augmentation
21 of Item 1730-001-001 of the Budget Act of 1994. It is the intent of the
22 Legislature that the funds required to administer this act for the 1995-96 fiscal
23 year and each fiscal year thereafter, shall be provided for in the annual Budget
24 Act.”); *see also* Department of Finance Bill Analysis of SB 469 (as amended
25 June 13, 1994), Vol. 3 Joint Exh. 19, JointExh: 0949 (indicating the FTB
26 estimates that it would incur costs of \$250,000 annually beginning in the 1995-
1996 year for system maintenance in connection with the LLC Act).

23 ⁹ *See* Stat. 1994, Ch. 1200 § 27, Vol. 1 Joint Exh. 9, JointExh: 0231
24 (enacting Corp. Code § 17705, which provided for an appropriation of \$234,000
25 “to the Secretary of State from the Secretary of State's Business Fees Fund for
26 expenditure in the 1994-95 fiscal year, to be expended on the initial program
costs and to initiate the development of an automated system to support the
program”).

27 ¹⁰ Department of Finance Bill Analysis of SB 469 (as amended
28 January 19, 1994), Vol. 2, Joint Exh. 18, JointExh: 0773 (indicating that the
Department of Corporations would not incur any significant costs attributable to
the LLC Act that is not recoverable through standard filing fees).

1 enacted a schedule of filing fees.¹¹ Such fees are deposited into the Secretary of
2 State's Business Fees Fund.¹²

3 Third, the proceeds generated by the Levy greatly exceed the cost of any
4 possible regulatory purpose the Levy might serve. Indeed, in fiscal years 1997
5 and 1998, the proceeds of the Levy were more than half of, and in all subsequent
6 years exceeded, the *entire* budget of the Secretary of State. Given the Secretary
7 of State's vast responsibilities, only a small portion of the budget can possibly be
8 attributed to activity related to LLCs. The fact that the proceeds from the Levy
9 were so significant confirms the Levy was not intended to reimburse the State for
10 costs associated with regulating or providing services to LLCs.

11 **III. DETERMINATION OF ISSUES**

12 For the reasons set forth below, this Court concludes that the Levy is a
13 tax. The Court further concludes that, as such, the Levy violates the "fair
14 apportionment" requirement of the Commerce and Due Process Clauses¹³ of the
15 United States Constitution.

16 **A. The Levy is a Tax**

17 The label assigned to a levy is not determinative of whether it is a tax or a
18 fee. *See, e.g., Weekes v. City of Oakland*, 21 Cal. 3d 386, 392 (1978) ("The
19 character of a tax is ascertained from its incidents, not its label."). Instead, "the
20 government bears the burden of proof" that the true substance of a levy is a fee
21 and not a tax under California law. *California Assn. of Prof. Scientists v. Dept.*

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23 ¹¹ *See* Stat. 1994, Ch. 1200 § 27, Vol. 1 Joint Exh. 9, JointExh: 0230-
24 0231 (enacting Corp. Code Sections 17700 through 17704, providing for LLC
filing fees).

25 ¹² *See* Gov. Code § 12176 (stating further, "It is the intent of the
26 legislature that moneys deposited into the Secretary of State's Business Fees
27 Fund shall be used to support the programs from which the fees are collected
[and] that the fees shall be sufficient to cover the costs of the programs.")

28 ¹³ For all of the same reasons, the Levy violates the Due Process Clause
of the California Constitution.

1 of *Fish & Game*, 79 Cal. App. 4th 935, 945 (2000).¹⁴ This is true
2 notwithstanding the fact that Plaintiff bears the ultimate burden of proof in this
3 case.

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

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

19 Likewise, the Levy is not a fee because it bears no relationship to benefits
20 received or burdens imposed by the payor.¹⁵ Under *United Business Commission*
21 *v. City of San Diego*, 91 Cal. App. 3d 156, 165 (1979), the amount of a
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24 ¹⁴ The FTB contends that the holding of *California Assn. of Prof.*
25 *Scientists* is limited to characterization of a levy as a tax or a fee for purposes of
26 California’s Proposition 13. The cases cited by the FTB do not support this
27 narrow interpretation. Moreover, assigning the burden of proving a levy is a tax
28 or a fee to the government reflects sensible policy because the government
possesses information necessary to make this determination.

¹⁵ In fact, NES received no services nor sought any particular benefits
from the State, but rather was subject to the Levy as a result of earning income
entirely outside of California.

1 regulatory license or permit fee “cannot exceed the sum reasonably necessary to
2 cover the costs of the regulatory purpose sought.” The FTB identifies the
3 relevant costs as “those incident to the issuance of the license or permit,
4 investigation, inspection, administration, maintenance of a system of supervision
5 and enforcement.” But the FTB never attempted to quantify these costs. Indeed,
6 the FTB has introduced no evidence that the Levy is related in any way to
7 regulating LLCs, or that its proceeds fund any regulatory program or otherwise
8 compensate for services provided by, and/or benefits received from, the
9 government. The FTB’s unsubstantiated claims that the benefits enjoyed by LLCs
10 are “highly valuable,” “immeasurable, and “clearly exceed the minimal amount of
11 the annual LLC fee” do not satisfy the FTB’s burden.

12 The FTB claims the Levy was enacted pursuant to the State’s police power,
13 and that it serves a regulatory purpose, by reference to the legislative history of
14 the LLC Act. In particular, the FTB quotes passages from the LLC Act stating
15 that it was necessary for “preservation of the public peace, health, or safety,”
16 and identifying certain regulatory functions of the LLC Act. (*See* Defendant’s
17 Opening Trial Brief, at page 5.)¹⁶ However, the FTB failed to establish how the
18 Levy itself (as opposed to the LLC Act as a whole) promotes public peace,
19 health, or safety or otherwise regulates LLCs.¹⁷

20 For all of the foregoing reasons, the Court holds that the Levy is a tax.
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24 ¹⁶ The Court notes that the passages quoted by the FTB also states that
25 the LLC Act will “improve California’s business climate *and tax base.*” *See id.*
at page 6 (emphasis supplied).

26 ¹⁷ Even if this Court could accept some regulatory purpose for the
27 Levy, for the reasons noted above, the Court must conclude the amount of the
28 Levy is not correlated to the cost of any such regulatory purpose because, as
stated above, the record contains no evidence of any costs associated with the
purported regulatory activities.

1 **B. The Levy is Unconstitutional Because It is Not Fairly**
2 **Apportioned**

3 Having concluded the Levy is a tax, the Court must also conclude the Levy
4 violates the Due Process and Commerce Clauses of the United States
5 Constitution. A fundamental constitutional principle governing state taxation
6 (grounded in the Due Process and Commerce Clauses) is that a state tax must be
7 fairly apportioned, *i.e.*, it must be calibrated to the level of activity in the State.
8 *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (a levy on
9 interstate commerce must (1) be “applied to an activity with a substantial nexus
10 with the taxing state”, (2) be “fairly apportioned”; (3) “not discriminate against
11 interstate commerce” and (4) be “fairly related to the services provided by the
12 state”); *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 189
13 (1995) (confirming the continuing applicability of *Complete Auto’s* four-part
14 test); *Hans Rees’ Sons, Inc. v. North Carolina*, 283 U.S. 123, 134 (1931) (a tax
15 will be struck down under the Due Process Clause if it seeks to “reach profits
16 which are in no just sense attributable to transactions within [the taxing
17 jurisdiction”).

18 The United States Supreme Court has further refined the fair
19 apportionment requirement to require both “internal consistency” and “external
20 consistency.” “Internal consistency is preserved when the imposition of a tax
21 identical to the one in question by every other State would add no burden to
22 interstate commerce that intrastate commerce would not also bear.” *Jefferson*
23 *Lines*, 514 U.S. at 184. “External consistency, on the other hand, looks not to
24 the logical consequences of cloning, but to the economic justification for the
25 State's claim upon the value taxed, to discover whether a State's tax reaches
26 beyond that portion of value that is fairly attributable to economic activity within
27 the taxing State.” *Id.*

1 The Levy fails both the internal and external consistency requirements of
2 the Constitution's fair apportionment requirement. By the terms of Rev. & Tax.
3 Code § 17942, the amount of the Levy is determined based upon "total income
4 from all sources reportable to this state," *i.e.*, worldwide gross receipts without
5 apportionment. *See* discussion at p. 3, *supra*. Applying the internal consistency
6 requirement, if one assumes the Levy were replicated in every state across the
7 country, an interstate LLC with the same total income as Plaintiff would pay the
8 maximum Levy in every jurisdiction in which it operated (or simply registered to
9 do business). By contrast, an LLC operating wholly within a single state would
10 pay the maximum Levy, but only once. Thus, interstate commerce plainly would
11 bear a greater burden than intrastate commerce, and the Levy fails the internal
12 consistency test. Moreover, as demonstrated by Plaintiff's alleged liability for
13 the Levy despite its lack of any activity in California, the Levy undeniably
14 "reaches beyond that portion of value that is fairly attributable to economic
15 activity within the taxing State." Stated differently, it is clear the Levy is not
16 calibrated to Plaintiff's California activity because Plaintiff engaged in none.
17 Therefore, the Levy also fails the external consistency requirement.

18 The courts have consistently and repeatedly struck down unapportioned
19 taxes as unconstitutional. *See, e.g., Central Greyhound Lines, Inc. v. Mealey*,
20 334 U.S. 653 (1948); *City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th
21 518 (2005); *City of Winchester v. American Woodmark Corp.*, 471 S.E.2d 495
22 (Va. 1996); *S. Pac. Transp. Co. v. Dep't of Revenue*, 44 P.3d 1006 (Ariz. Ct.
23 App. 2002).

24 Simply, because the Levy is unapportioned, it violates the Commerce and
25 Due Process Clauses. As such, the Levy cannot constitutionally be applied to
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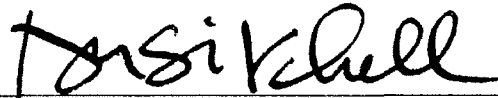
1 Plaintiff, and Plaintiff is entitled to a full refund all of its payments pursuant to
2 Rev. & Tax. Code § 17942 for the Years at Issue.¹⁸

3 **IV. ORDER**

4 1. Plaintiff, Northwest Energetic Services, LLC, is the prevailing party
5 and is entitled to judgment against Defendant, Franchise Tax Board, for a full
6 refund of all amounts it paid (including all interest and penalties) pursuant to
7 Section 17942 for the calendar years 1997 and 1999 through 2001, plus refund
8 interest as provided by law.

9 2. This Proposed Statement of Decision shall be the Statement of
10 Decision unless, within fifteen days, either party specifies issues or makes
11 proposals not contained herein. The Plaintiff is to prepare a form of judgment
12 consistent with this order and the Statement of Decision.

13 Dated: March 2, 2006



14 **DONALD S. MITCHELL**
15 Judge of the Superior Court

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23 ¹⁸ Even if the Levy were deemed a fee, the Court finds that it would be
24 subject to the fair apportionment requirement of the Commerce and Due Process
25 Clauses of the United States Constitution. *See American Trucking Ass'ns v.*
26 *Scheiner*, 483 U.S. 266, 285 (1987) (applying the fair apportionment requirement
27 to strike down an unapportioned fee); *American Trucking Ass'ns, Inc. v.*
28 *Michigan Public Service Comm'n*, 125 S. Ct. 2419, 2425 (2005) (citing
American Trucking Ass'ns v. Scheiner with approval). The Court rejects any
reliance on *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970) (analyzing under the
Commerce Clause a regulation dictating the manner in which cantaloupes grown
in Arizona must be packed), because the FTB has cited no authority for extending
the case to monetary impositions by the government.

1 CERTIFICATE OF SERVICE BY MAIL

2 (Code Civ. Proc. 1013a(4))

3
4 I, Iris Hammer, a deputy clerk of the Superior Court for the City and County of
San Francisco, certify that:

5 1) I am not a party to this action;

6 2) On MAR 3 2006, I served the attached:

7
8
9 PROPOSED STATEMENT OF DECISION

10
11 by placing a copy thereof in a sealed envelope, addressed as follows:

12
13 Marguerite C. Stricklin, Esquire
14 Deputy Attorney General
15 Office of the Attorney General
16 1515 Clay Street, 20th Floor
17 Oakland, CA 94612-0550

Amy L. Silverstein, Esquire
Silverstein & Pomerantz, LLP
55 Hawthorne Street, Suite 440
San Francisco, CA 94105

18 and,

19 3) I then placed the sealed envelope in the outgoing mail at 400 McAllister
20 Street, San Francisco, CA 94102-4514 on the date indicated above for collection, attachment of
required prepaid postage, and mailing on that date following standard court practices.

21 DATED: MAR 3 2006

GORDON PARK-LI, Clerk

22
23
24 By:  Deputy
25 IRIS L. HAMMER