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9 SUPERIOR COURT OF CALIFORNIA
10 FOR THE CITY AND COUNTY OF SAN FRANCISCO

11
12 **NORTHWEST ENERGETIC SERVICES, LLC,**
13 Plaintiff.
14 v.
15 **FRANCHISE TAX BOARD,**
16 Defendant.

CGC 05-437721

**DEFENDANT'S OBJECTIONS
TO PROPOSED STATEMENT
OF DECISION**

[Cal. Rules of Court, Rule 232(d)]

Trial Date: November 21, 2005
Action Filed: January 13, 2005

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18 Pursuant to the court's Order and California Rules of Court, Rule 232(d), defendant
19 Franchise Tax Board (hereinafter "the Board") hereby submits its objections to the Proposed
20 Statement of Decision served by mail on March 3, 2006, as follows:

21 **Findings of Fact.**

22 1. Page 2, lines 12-13: The reference to "the \$800 minimum tax imposed on LLCs
23 under Revenue and Taxation Code section 17941," is technically inaccurate. Revenue and
24 Taxation Code section 17941 states that it imposes an annual tax of \$800, not a minimum tax.
25 The Proposed Statement of Decision contains additional references to "minimum tax" on page 4,
26 line 15, and page 4 line 26 in footnote 5. All these references to a "minimum tax" should be
27 corrected to refer instead to the annual tax."

28 2. Page 4, lines 9-12 and footnote # 4: The proposed decision states, "Because

1 corporations are subject to a franchise tax (based on income) but LLCs are not, [footnote 3] the
2 Legislature predicted an increasing number of businesses would operate as LLCs rather than as
3 corporations, resulting in a decrease in income tax revenues. [footnote 4]” Footnote 4 further
4 states, “See FTB Bill Analysis for SB 930 (as introduced), dated August 11, 1993, Vol. 6 Joint
5 Exh. 39, JointExh: 1960.”

6 Contrary to the sentence quoted above, the support cited in footnote 4 for a prediction
7 of the Legislature is a Franchise Tax Board Bill Analysis. Since it is a Board Bill Analysis, it
8 could not be the Legislature’s prediction. Moreover, there is, in fact, no prediction anywhere in
9 this Bill Analysis that an increasing number of businesses would operate as LLCs rather than
10 corporations, nor is there any prediction that this would happen because corporations are subject
11 to a franchise tax LLCs would not subject to such a tax. The Bill Analysis is very cautious about
12 the future of LLCs because of several uncertainties in the law affecting LLCs. For example,
13 under “Background” it states: “Because it is uncertain if the U.S. Constitution requires another
14 state to recognize the limited liability feature and other LLC related laws prevailing in the state in
15 which an LLC is organized, further evolvement of LLCs depends upon the remaining states
16 authorizing them by statute.” Also, under the section headed “Tax Revenue Estimate” the Bill
17 Analysis states: “The revenue impact of this proposal is difficult to estimate due to many
18 uncertainties, such as future economic conditions and the rate at which businesses will use LLC
19 status.” More importantly, however, is the fact that this Bill Analysis refers to “SB 930 (as
20 introduced)”, a bill that never became law. The Legislature enacted SB 469 instead to allow the
21 formation, operation, and regulation of LLCs in California.

22 **Determination of Issues.**

23 3. Page 7, lines 4-6: The proposed decision states that, “The essence of a tax is that it
24 raises revenue for general governmental purposes and is ‘compulsory rather than imposed in
25 response to a voluntary decision . . . to seek benefits.’ (Citation omitted.)” This statement of law
26 as applied to this case, however, does not support the court’s conclusion that Revenue and
27 Taxation Code section 17942 imposes a tax. The plaintiff in this case voluntarily registered with
28 the California Secretary of State and by that single, *noncompulsory* act made itself subject to the

1 LLC fee pursuant to Revenue and Taxation Code section 17942. To Board’s knowledge and
2 belief, no one from the State of California contacted plaintiff and requested or compelled it to
3 register with the California Secretary of State.

4 4. Page 7, line 19 to page 8, line 11, and footnote # 15: This paragraph of the
5 proposed decision states: “Likewise, the Levy is not a fee because it bears no relationship to
6 benefits received or burdens imposed by the payor. [footnote 15] Under *United Business*
7 *Commission v. City of San Diego*, 91 Cal. App. 3d 156, 165 (1979), the amount of a regulatory
8 license or permit fee ‘cannot exceed the sum reasonably necessary to cover the costs of the
9 regulatory purpose sought.’ The FTB identifies the relevant costs as ‘those incident to the
10 issuance of the license or permit, investigation, inspection, administration, maintenance of a
11 system of supervision and enforcement.’ But the FTB never attempted to quantify these costs.
12 Indeed, the FTB has introduced no evidence that the Levy is related in any way to regulating
13 LLCs, or that its proceeds fund any regulatory program or otherwise compensate for services
14 provided by, and/or benefits received from, the government. The FTB’s unsubstantiated claims
15 that the benefits enjoyed by LLCs are ‘highly valuable,’ ‘immeasurable [*sic*], and ‘clearly exceed
16 the minimal amount of the annual LLC fee’ do not satisfy the FTB’s burden.” Footnote 15
17 further states, “In fact, NES received no services nor sought any particular benefits from the State
18 . . .” However, in fact by reason of plaintiff’s registration with the California Secretary of State,
19 NES had the right to conduct lawful business in California (including the right to operate as an
20 entity subject to limited liability); the right of access to the courts of California; and protection of
21 the LLC’s business name under California law.

22 Contrary to the conclusions in this paragraph, and assuming that the Board had the
23 burden to do so, which the Board disputes, the Board did present evidence regarding the costs of
24 allowing the formation, operation, and regulation of LLCs in California and how the LLC fee is
25 related to the regulation of LLCs. The evidence is contained in the joint exhibits submitted by
26 the parties. For example, the Board presented a copy of its report to the Legislature,
27 “Methodology for the Limited Liability Company Fee Adjustment Calculation,” dated August 9,
28 1994 (Joint Exhibit 19, JointExh: 0976-00982, and SB 469, Section 67), that the Legislature used

1 to calculate the costs of allowing the formation, operation, and regulation of LLCs in California
2 and to establish the initial amounts for the four-tiered LLC fees, so that the LLC fee would be
3 revenue neutral. Pursuant to the LLC Act, the Board was required annually to

4 conduct a study using the methodology and assumptions set forth in the report dated
5 August 9, 1994, and titled "Methodology for the Limited Liability Company Fee
6 Adjustment Calculation," which is hereby incorporated by reference into this section.
7 The study shall be submitted to the Joint Legislative Budget Committee and made
8 available, upon request, to any Member of the Legislature. If the Franchise Tax Board
9 determines, in accordance with the methodology and assumptions set forth in the study
10 referenced in this subdivision that the act that added this section results in a net gain or
11 reduction in state income and franchise tax revenues, the Franchise Tax Board annually
12 shall, after a public hearing, increase or decrease the amounts of the fees imposed under
13 Section 23092 [the predecessor of section 17942] in a manner that offsets the computed
14 revenue gain or loss.

15 Thus the difference in the amount of revenue received before and after LLCs were allowed to
16 operate in California is related to the cost of allowing the formation, operation, and regulation of
17 LLCs in this State. The Board also presented this and other evidence to show how the LLC fee is
18 related to regulating LLCs. As the Board stated in the Proposed Statement of Decision it
19 submitted to the court:

20 The main purpose of the LLC fee is not to raise revenue. As the Court of Appeal stated
21 in the *Professional Scientists* case:

22 Ordinarily, "taxes are imposed for revenue purposes, rather than in return for a specific
23 benefit conferred or privilege granted" and "[m]ost taxes are compulsory rather than
24 imposed in response to a voluntary decision to develop or to seek other government
25 benefits or privileges." (79 Cal.App.4th 935, 944, *citing Sinclair Paint Co. v. State Bd.*
26 *of Equalization supra*, 15 Cal.4th at p. 874.)

27 If revenue is the primary purpose, and regulation is merely incidental, the imposition is a tax; but,
28 if regulation is the primary purpose, *the mere fact that revenue is also obtained does not make the*
29 *imposition a tax. (United Business Com. v. City of San Diego (1979) 91 Cal.App.3d 156, 165 .)*

30 Fees, on the other hand:

31 "do not exceed the reasonable cost of providing services necessary to the activity for
32 which the fee is charged and [they] are not levied for unrelated revenue purposes."
33 (*Sinclair, supra*, 15 Cal.4th 866 at p. 876, 64 Cal.Rptr.2d 447, 937 P.2d 1350, internal
34 quotation marks omitted; *Townzen v. County of El Dorado* (1998) 64 Cal.App.4th
35 1350, 1359, 76 Cal.Rptr.2d 281.) "A regulatory fee may be imposed under the police
36 power when the fee constitutes an amount necessary to carry out the purposes and
37 provisions of the regulation." (*San Diego Gas & Electric Co. v. San Diego County*
38 *Air Pollution Control Dist.* (1988) 203 Cal.App.3d 1132, 1146, fn. 18, 250 Cal.Rptr.
39 420.) "Such costs ... include all those incident to the issuance of the license or permit,

1 investigation, inspection, administration, maintenance of a system of supervision and
2 enforcement. (*United Business Com. v. City of San Diego* (1979) 91 Cal.App.3d 156,
3 165, 154 Cal.Rptr. 263.) Regulatory fees are valid despite the absence of any
4 perceived “benefit” accruing to the fee payers. (*Pennell v. City of San Jose* (1986) 42
5 Cal.3d 365, 375, 228 Cal.Rptr. 726, 721 P.2d 1111, *affd.* on other grounds *sub nom.*
6 *Pennell v. City of San Jose* (1988) 485 U.S. 1, 108 S.Ct. 849, 99 L.Ed.2d 1.)
7 Legislators “need only apply sound judgment and consider ‘probabilities according
8 to the best honest viewpoint of informed officials’ in determining the amount of the
9 regulatory fee.” (*United Business Com. v. City of San Diego, supra*, 91 Cal.App.3d
10 at p. 166, 154 Cal.Rptr. 263.)

11 (*Professional Scientists, supra*, 79 Cal.App.4th at p. 945.)

12 The evidence demonstrates that the primary purpose of the LLC Act and the LLC fee
13 was to allow for the creation and existence of businesses to operate as LLCs in California, not to raise
14 revenue. (See Joint Exhibit 19.) A report on the enrolled bill states:

15 This bill would establish the Beverly-Killea Limited Liability Company Act,
16 permitting the formation of LLCs under California law by two or more persons who
17 file articles of organization with the Secretary of State and execute an operating
18 agreement among the members. It would vest in LLCs organized in California all the
19 rights and powers enjoyed by a natural person in carrying out business affairs,
20 including

- 21 • transact business in any state, territory, district or possession of the United
22 States or in any foreign territory;
- 23 • sue or defend in its own name in any administrative or judicial proceeding;
- 24 • adopt and use a company seal;
- 25 • enter into contracts, make guarantees, act as a surety and borrow and lend
26 money;
- 27 • acquire and dispose of property and assets;
- 28 • invest surplus funds;
- indemnify or hold harmless any person;
- hold an interest in any entity and any obligations of the U.S. Government or
its subdivisions;
- act as an employer and pay salaries and other compensation;
- make charitable donations; and
- commit any other act which further the business of the organization and which
does not conflict with another law.

29 This bill contains numerous definitions, specifications and other provisions
30 related to the formation, administration and governance of California LLCs. . . .

31 However, this bill would not allow the formation of LLCs (foreign or
32 domestic) in California to render any type of professional services for which a license,
33 certification or registration is required under the Business and Professions Code or the
34 Chiropractic Act.

35 (Franchise Tax Board Enrolled Bill Report, Joint Exhibit 19, JointExh: 1039-1040.) The Legislature
36 computed the revenue impact of the LLC Act as the difference between the taxes and fees that were
37 paid by LLCs for the tax year and the amount that would have been paid had LLCs not been allowed
38 to operate in California. (Joint Exhibits 6-8.) Also, while it is true that the LLC fee is used for
general fund purposes and not for a special fund for specific quantifiable benefits or services,

1 California law does provide the certain specified benefits listed above to foreign LLCs that are
2 registered, *e.g.*, business name protection, access to the California judicial system, and ability to
3 conduct activities in California as an LLC while its members enjoy limited liability. (See Franchise
4 Tax Board Enrolled Bill Report, Joint Exhibit 19, JointExh: 1040.) These public services and
5 facilities are paid for by general funds rather than special funds

6 Plaintiff's claim that "there is no mention anywhere in the legislative history of any
7 regulatory scheme the Levy might support" is incorrect. The legislative history shows that the LLC
8 fee was an integral part of the Legislature's decision to authorize and regulate the formation and
9 operation of LLCs in California.

10 The Franchise Tax Board (FTB) would be required to develop a report in 1994
11 setting forth the methodology and assumptions that would be used to determine the
12 effect of recognizing LLCs on state tax revenues, which would be submitted to the
13 Joint Legislative Budget Committee. Beginning with the 1999 tax year, the FTB
14 would conduct an annual revenue estimate using these specified methodologies and
assumptions to determine if state revenues had increased or decreased as a result of
business entities organized as LLCs in California. If the FTB noted a change in state
revenues because of the recognition of LLCs, the FTB would be authorized, after a
public hearing, to adjust the schedule of LLC fees to balance the revenue impact.

15 (Department of Finance Enrolled Bill Report, Joint Exhibit 19, JointExh: 1047; and see
16 "Methodology for the Limited Liability Company Fee Adjustment Calculation, August 9, 1994, Joint
17 Exhibit 19, JointExh: 0976-00982, and SB 469, Section 67.)

18 Plaintiff's own cite to Joint Exhibit 18, JointExh: 0819-0821 (Senate Floor Analysis
19 dated January 26, 1994) refutes its argument that "[t]he legislative history makes clear that the sole
20 purpose of the levy was to raise revenue." (Pls. Op.Brif., at p. 4, lines 13-14.) Nothing in this
21 analysis supports Plaintiff's claim. The Senate Floor Analysis reviews how the LLC Act would
22 authorize formation of LLCs in California, the rights and powers to be provided to LLCs, the
23 assessment of the annual tax, and explains the LLC fee. As part of the regulatory nature of the LLC
24 Act, the LLC Act imposed both the tax pursuant to section 17941, and the LLC fee, pursuant to
25 section 17942. These measures were implemented in a revenue neutral manner.

26 Plaintiff's contention that because the amount of the LLC fees collected exceeds the
27 "entire budget of the Secretary of State, the only agency that could potentially be deemed responsible
28 for regulating LLCs" the LLC fee is tax and not a fee ignores the reality of the Legislature's

1 authorization of LLCs to conduct business in California. The Secretary of State is not the only
2 agency that regulates LLCs. For example, the Board processes an LLC's Return of Income (Form
3 568), audits the Form 568 when a taxpayer fails to properly report its total income and refuses to pay
4 the LLC fee, and sends notices indicating when an assessment is not paid. Additionally, before an
5 LLC may cancel its registration with the Secretary of State, the LLC must request a Tax Clearance
6 Certificate from the Board and demonstrate all outstanding amounts have been paid.

7 The singular focus upon the California Secretary of State as the sole entity undertaking
8 regulatory activity is misplaced. The fact that the Board or other state agencies involved in the
9 regulation of LLCs may not have an independent regulatory program or a special fund for the purpose
10 of regulating LLCs is not dispositive. In concluding that the State Department of Fish and Game
11 undertook regulatory activities, the California Court of Appeal in *Professional Scientists, supra*, 79
12 Cal.App.4th 935 held:

13 The fact that Fish and Game does not operate an independent regulatory program with
14 a correlative accounting system does not detract from its regulatory role. *The law is*
15 *not so narrowly drawn.* In a similar vein, the court in *Sinclair Paint Co. v. State Bd.*
16 *of Equalization* (1997) 15 Cal. 4th 866 [64 Cal. Rptr. 2d 447, 937 P.2d 1350]
17 observed: "From the viewpoint of general police power authority, we see no reason
18 why statutes or ordinances calling on polluters or producers of contaminating
19 products to help in mitigation or cleanup efforts should be deemed less 'regulatory'
20 in nature than the initial permit or licensing programs that allowed them to operate.
21 Moreover, imposition of 'mitigating effects' fees in a substantial amount...also
22 'regulates' future conduct by deterring further manufacture, distribution, or sale of
23 dangerous products, and by stimulating research and development efforts to produce
24 safer or alternative products. (Italics added.)

25 One merely needs to look at the various state entities involved in the current suit for
26 refund, including the Board, the Secretary of State, the State Board of Equalization (the "SBE"), the
27 Attorney General's Office of the Department of Justice, and the Superior Court of California for the
28 City and County of San Francisco, all of which undertook actions regulatory in nature, to see the
exclusive focus upon the Secretary of State is wrong. As the Court in *Professional Scientists* stated
the law is not so narrowly drawn. (79 Cal.App.4th at p. 942.) Finally, it should be noted that all of
the above entities receive funding from the State's General Fund, which is precisely where the LLC
fees are deposited.

1 Moreover, contrary to Plaintiff’s claim that “the Levy is identical to California’s net
2 income tax on corporations in that payment confers the right to carry on business without any further
3 conditions, a foreign LLC must pay the LLC fee *and* fulfill additional conditions before the LLC has
4 the right to carry on intrastate business in California. In addition to payment of the LLC fee, a
5 foreign LLC must have registered with the California Secretary of State, filed the appropriate
6 paperwork, filed a timely LLC Return of Income annually, and paid the tax imposed pursuant to
7 section 17941. Furthermore, unlike the net income tax on corporations, the LLC fee is capped to a
8 maximum amount based on an LLC’s total income. Thus, Plaintiff’s contention that the payment of
9 the LLC fee confers the right to carry on business without any further conditions, and therefore the
10 LLC fee is a tax, is incorrect.

11 The fact that the LLC fee is administered according to provisions for administering
12 California’s income tax rather than California’s “Fee Collection Procedures Law,” also does not
13 make it a tax. Section 55001 *et seq.*, also known as the “Fee Collection Procedures Law” applies
14 to the actions of the SBE, not the Franchise Tax Board. Specifically, section 55003 defines the term
15 “Board” as the SBE. The Franchise Tax Board is not included in the definition. The Fee Collection
16 Procedures Law does not apply to the Franchise Tax Board and the California Legislature determined
17 the Franchise Tax Board should collect the LLC fee.

18 The Legislature enacted the LLC fee pursuant to its police power as an integral part
19 of a revenue neutral statute that has as its primary purpose the regulation of LLCs. Thus, the LLC fee
20 imposed pursuant to section 17942 is a fee, not a tax.

21 5. Page 11, footnote # 18, lines 23-26: The proposed decision states at footnote 18,
22 “Even if the Levy were deemed a fee, the Court finds that it would be subject to the fair
23 apportionment requirement of the Commerce and Due Process Clauses of the United States
24 Constitution. *See American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 285 (1987) (applying the fair
25 apportionment requirement to strike down an unapportioned fee); *American Trucking Ass'ns, Inc. v.*
26 *Michigan Public Services Comm'n*, 125 S. Ct.2419, 2425 (2005)(citing *American Trucking Ass'ns v.*
27 *Scheiner* with approval).” The cases cited, however, do not support the conclusion set forth in the
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