

FILED
San Francisco County Superior Court
APR 18 2006
GORDON PARK-LI, Clerk
Deputy Clerk

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

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

STATEMENT OF DECISION

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

This matter was tried in Department 602 of the Superior Court,
County of San Francisco, the Honorable Donald S. Mitchell, Judge,
presiding. The Plaintiff, Northwest Energetic Services, LLC, appeared
through counsel, Amy L. Silverstein, Esq. and Edwin P. Antolin,
Esq., Silverstein & Pomerantz, LLP. The Defendant, California Franchise
Tax Board, appeared through counsel, Bill Lockyer, Attorney General of
the State of California, and Marguerite C. Stricklin, Esq., Deputy Attorney
General, State of California.

The Court filed its Proposed Statement of Decision on March 3, 2006. The
Defendant filed objections to the Court's Proposed Statement of Decision on

1 March 22, 2006. Plaintiff filed a reply to Defendant's objections on March 29,
2 2006. After considering those objections and the reply as well as the evidence
3 submitted in this case, the Court makes the following Statement of Decision:

4 **I. INTRODUCTION**

5 The sole issue in this case is whether California's levy on limited liability
6 companies ("LLCs"), codified as Cal. Rev. & Tax. Code § 17942 (hereinafter the
7 "Levy" or "Section 17942"),¹ violates the Commerce Clause of the United States
8 Constitution or the Due Process Clauses of the United States Constitution. The
9 Court finds that the Levy indeed violates both the Commerce and Due Process
10 Clauses. Accordingly, it cannot be applied to Plaintiff Northwest Energetic
11 Services, LLC ("Plaintiff" or "NES"), and Plaintiff is entitled to a full refund of
12 all amounts it paid (including interest and penalties) pursuant to Section 17942 for
13 the calendar years 1997 and 1999 through 2001 (the "Years at Issue"), plus refund
14 interest as provided by law.

15 **II. FINDINGS OF FACT**

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

18 **A. Procedural Background**

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

26
27
28 ¹ All section references are to the Revenue and Taxation Code unless
otherwise noted.

1 After notification by the FTB of an alleged balance due, Plaintiff paid
2 \$27,458.13 pursuant to Rev. & Tax. Code § 17942 for the Years at Issue
3 (including late payment penalties and interest), and canceled its registration with
4 the California Secretary of State. (JS ¶ 12.) On February 21, 2003, Plaintiff
5 timely filed a claim for refund of the foregoing amount, and thereafter exhausted
6 administrative remedies with respect to the claim. (JS ¶¶ 13-17.)

7
8 **B. Plaintiff's Business**

9 During the Years at Issue, NES was an LLC organized under the laws of the
10 State of Washington. (JS ¶ 4.) Plaintiff distributed explosives and explosives-
11 related services to customers located solely outside California. Plaintiff's only
12 business locations were in Washington and Oregon. (JS ¶ 5.)

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

22 **C. The Levy**

23 **1. Application and Computation of the Levy**

24 Section 17942(a) provides that the Levy is applicable to "every limited
25 liability company subject to tax under Section 17941." Under Section 17941,
26 LLCs are subject to tax and, therefore, to the Levy if either (a) they are "doing
27 business" in California, or (b) even if they are not doing business in California,
28 their articles of organization have been accepted by the California Secretary of

1 State or they have received a certificate of registration from the California
2 Secretary of State.

3 Pursuant to Section 17942(a), an LLC's liability for the Levy is computed
4 on the basis of its "total income from all sources reportable in this state for the
5 taxable year."² The parties agree, and this Court finds, that "total income from all
6 sources reportable in this state for the taxable year" means the LLC's "total
7 income," without apportionment. Whereas apportionment would remove from the
8 taxable base income earned outside California's borders, the Levy applies to an
9 LLC's entire income, wherever earned. Due to this absence of any apportionment
10 mechanism for the Levy, any LLC earning the same amount of total income as
11 Plaintiff earned annually would pay the same Levy as Plaintiff, even if it
12 conducted all of its activity in California.

14 **2. Purpose of the Levy and Use of Its Proceeds**

15 The Levy was enacted in 1994 as part of the California Limited Liability
16 Company Act (Senate Bill 469) ("LLC Act"), which authorized LLCs for the first
17 time to organize and register in the State. Because of the favorable tax treatment
18 of a LLC, the FTB Bill Analysis projected a decline in tax revenue following the
19 adoption of SB 930.³ The Bill Analysis predicted an increasing number of
20 businesses would operate as LLCs rather than as corporations, resulting in a
21
22

23
24 ² Section 17942(b)(1) defines "total income" as "gross income as
25 defined in Section 24271, plus the cost of goods sold that are paid or incurred in
26 connection with the trade or business of the taxpayer." This amount is also
commonly referred to as a taxpayer's "gross receipts."

27 ³ Unless it elects otherwise, an LLC is not subject to tax by California
28 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.

1 decrease in income tax revenues.⁴ Thus, to offset this loss in tax revenue, the
2 Legislature added to the LLC Act two revenue raising provisions: Section 17942
3 (which imposed the Levy) and Section 17941 (which imposed an \$800 minimum
4 tax).⁵ The law set the Levy for the first few years at graduated amounts that
5 depended upon the range into which the LLC's total income fell.⁶ The law also
6 directed the FTB to analyze annually, beginning in 1999, the revenue impact of the
7 LLC Act, and empowered the FTB to adjust the amount of the Levy so that the
8 revenue generated by the Levy and the minimum tax equaled the amount of lost
9 corporate income tax revenues.⁷ Based on the record, the Court finds the Levy
10 was designed to replace lost income tax revenue and, therefore, the purpose of the
11 Levy was to raise revenue. This conclusion is bolstered by evidence in the record
12 that all proceeds from the Levy were and are deposited in the State's general fund.
13 (JS ¶ 18.)

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

20 ⁴ See FTB Bill Analysis for SB 930 (as introduced), dated August 11,
21 1993, Vol. 6 Joint Exh. 39, JointExh: 1960.

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

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

⁷ *Id.* (enacting Cal. Rev. & Tax. Code § 23093), Vol 1 Joint Exh. 9,
JointExh: 0265.

⁸ See Stat. 1994, Ch. 1200 § 94, Vol. 1 Joint Exh. 9, JointExh: 0276
("For purposes of implementing and administering this act in the 1994-95 fiscal

1 Second, to reimburse the one agency that would incur ongoing costs
2 associated with processing LLC filings, the Secretary of State, the Legislature
3 enacted a schedule of filing fees.¹¹ Such fees are deposited into the Secretary of
4 State's Business Fees Fund.¹²

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

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

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

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

25 ¹¹ *See* Stat. 1994, Ch. 1200 § 27, Vol. 1 Joint Exh. 9, JointExh: 0230-
26 0231 (enacting Corp. Code Sections 17700 through 17704, providing for LLC
27 filing fees).

27 ¹² *See* Gov. Code § 12176 (stating further, “It is the intent of the
28 legislature that moneys deposited into the Secretary of State's Business Fees 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.”)

1 **III. DETERMINATION OF ISSUES**

2 For the reasons set forth below, this Court concludes that the Levy is a tax.
3 The Court further concludes that, as such, the Levy violates the “fair
4 apportionment” requirement of the Commerce and Due Process Clauses¹³ of the
5 United States Constitution.

6 **D. The Levy is a Tax**

7 The label assigned to a levy is not determinative of whether it is a tax or a
8 fee. *See, e.g., Weekes v. City of Oakland*, 21 Cal. 3d 386, 392 (1978) (“The
9 character of a tax is ascertained from its incidents, not its label.”). Instead, “the
10 government bears the burden of proof” that the true substance of a levy is a fee
11 and not a tax under California law. *California Assn. of Prof. Scientists v. Dept. of*
12 *Fish & Game*, 79 Cal. App. 4th 935, 945 (2000).¹⁴ This is true notwithstanding the
13 fact that Plaintiff bears the ultimate burden of proof in this case.

14 The essence of a tax is that it raises revenue for general governmental
15 purposes and is “compulsory rather than imposed in response to a voluntary
16 decision . . . to seek benefits.” *Sinclair Paint Co. v. State Bd. of Equaliz.*, 15 Cal.
17 4th 866, 874 (1997). A fee, by contrast, must fund a regulatory program or
18 compensate for services provided by, and/or benefits received from, the
19 government. *Id.* at 874-75 (describing three types of fees—regulatory fees,
20 development fees, and special assessments).

21 In this case, the Levy is clearly a tax. As noted above, the record in this
22 case confirms the purpose of the Levy is to raise revenue. *See* discussion at pp. 2-

23 _____
24 ¹³ For all of the same reasons, the Levy violates the Due Process Clause
25 of the California Constitution.

26 ¹⁴ The FTB contends that the holding of *California Assn. of Prof.*
27 *Scientists* is limited to characterization of a levy as a tax or a fee for purposes of
28 California’s Proposition 13. The cases cited by the FTB do not support this
narrow interpretation. Moreover, assigning the burden of proving a levy is a tax
or a fee to the government reflects sensible policy because the government
possesses information necessary to make this determination.

1 4, *supra*. Moreover, unlike the revenue from a fee, which must be dedicated to its
2 purpose, *e.g.*, the regulatory scheme it is intended to fund, the Levy is intended
3 for, and used solely for, general governmental purposes. (JS ¶ 18.) *See*
4 discussion at p. 4, *supra*. In light of the revenue raising purpose and the deposit
5 of the proceeds into the general fund for general governmental purposes, the Levy
6 is a tax.

7 Likewise, the Levy is not a fee because it bears no relationship to benefits
8 received or burdens imposed by the payor.¹⁵ Under *United Business Commission v.*
9 *City of San Diego*, 91 Cal. App. 3d 156, 165 (1979), the amount of a regulatory
10 license or permit fee “cannot exceed the sum reasonably necessary to cover the
11 costs of the regulatory purpose sought.” The FTB identifies the relevant costs as
12 “those incident to the issuance of the license or permit, investigation, inspection,
13 administration, maintenance of a system of supervision and enforcement.” But the
14 FTB never attempted to quantify these costs. Indeed, the FTB has introduced no
15 evidence that the Levy is related in any way to regulating LLCs, or that its
16 proceeds fund any regulatory program or otherwise compensate for services
17 provided by, and/or benefits received from, the government. The FTB’s
18 unsubstantiated claims that the benefits enjoyed by LLCs are “highly valuable,”
19 “immeasurable, and “clearly exceed the minimal amount of the annual LLC fee” do
20 not satisfy the FTB’s burden.

21 The FTB claims the Levy was enacted pursuant to the State’s police power,
22 and that it serves a regulatory purpose, by reference to the legislative history of
23 the LLC Act. In particular, the FTB quotes passages from the LLC Act stating
24 that it was necessary for “preservation of the public peace, health, or safety,” and
25 identifying certain regulatory functions of the LLC Act. (*See* Defendant’s
26

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

1 Opening Trial Brief, at page 5.)¹⁶ However, the FTB failed to establish how the
2 Levy itself (as opposed to the LLC Act as a whole) promotes public peace, health,
3 or safety or otherwise regulates LLCs. ¹⁷

4 For all of the foregoing reasons, the Court holds that the Levy is a tax.

5 **E. The Levy is Unconstitutional Because It is Not Fairly**
6 **Apportioned**

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

21 The United States Supreme Court has further refined the fair apportionment
22 requirement to require both “internal consistency” and “external consistency.”

23
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 Levy,
27 for the reasons noted above, the Court must conclude the amount of the Levy is
28 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 “Internal consistency is preserved when the imposition of a tax identical to the
2 one in question by every other State would add no burden to interstate commerce
3 that intrastate commerce would not also bear.” *Jefferson Lines*, 514 U.S. at 184.
4 “External consistency, on the other hand, looks not to the logical consequences of
5 cloning, but to the economic justification for the State's claim upon the value
6 taxed, to discover whether a State's tax reaches beyond that portion of value that
7 is fairly attributable to economic activity within the taxing State.” *Id.*

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

25 The courts have consistently and repeatedly struck down unapportioned
26 taxes as unconstitutional. *See, e.g., Central Greyhound Lines, Inc. v. Mealey*, 334
27 U.S. 653 (1948); *City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th 518
28

1 (2005); *City of Winchester v. American Woodmark Corp.*, 471 S.E.2d 495 (Va.
2 1996); *S. Pac. Transp. Co. v. Dep't of Revenue*, 44 P.3d 1006 (Ariz. Ct. App.
3 2002).

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

8 ///

9 ///

10 ///

11 ///

12 ///

13 ///

14 ///

15 ///

16 ///

17 ///

18 ///

19 ///

20 ///

21 ///

22

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. Michigan*
28 *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
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

IV. ORDER

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

2. The Plaintiff is to prepare a form of judgment consistent with this order and the Statement of Decision.

Dated: April 12, 2006



DONALD S. MITCHELL
Judge of the Superior Court

SUPERIOR COURT OF CALIFORNIA
County of San Francisco

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

Plaintiff(s)

vs.

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

Defendant(s)

Case Number: 437721

CERTIFICATE OF MAILING
(CCP 1013a (4))

I, Iris Hammer, a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On April 13, 2006 I served the attached STATEMENT OF DECISION by placing a copy thereof in a sealed envelope, addressed as follows:

Marguerite C. Stricklin, Esq.
Deputy Attorney General
Office of the Attorney General
1515 Clay Street, 20th Floor
Oakland, CA 94612-0550

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

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

Dated: April 13, 2006

GORDON PARK-LI, Clerk

By: _____



Iris Hammer, Deputy Clerk