

**STATE OF CALIFORNIA
FINANCE LETTER - COVER SHEET
FOR FISCAL YEAR 2008/09
DF-46 (REV 03/03)**

**Department of Finance
915 L Street
Sacramento, CA 95814
IMS Mail Code: A-15**

FL # 3	PRIORITY NO	ORG CODE 1730	DEPARTMENT Franchise Tax Board
PROGRAM Tax Program	ELEMENT 20- Bank & Corp Tax	COMPONENT	

TITLE OF PROPOSED CHANGE:

Limited Liability Company Protective Claims - Processing and Attorney Fees

SUMMARY OF PROPOSED CHANGE:

The Franchise Tax Board (FTB) requests an augmentation of \$723,000 and 3 two-year limited term positions (2.8 PYs) to pay potential attorney fee judgments and process refunds resulting from the January 31st decision by the Court of Appeal in Northwest Energetic Services, LLC v. Franchise Tax Board, and in anticipation of a Court of Appeal decision in Ventas Finance I, LLC v. Franchise Tax Board. This proposal would satisfy judgment for attorney fees and litigation costs awarded by the court in these cases. Also, this proposal would allow for refunds to be processed for LLCs that have no activities in California, as the Court has determined in Northwest that the LLC fee is a tax that is unconstitutionally applied on these entities.

REQUIRES LEGISLATION <input type="checkbox"/> YES <input checked="" type="checkbox"/> NO	CODE SECTION(S) TO BE AMENDED/ADDED	BUDGET IMPACT-PROVIDE LIST AND MARK IF APPLICABLE <input checked="" type="checkbox"/> ONE-TIME COST <input type="checkbox"/> FUTURE SAVINGS <input checked="" type="checkbox"/> FULL-YEAR COSTS <input type="checkbox"/> REVENUE <input checked="" type="checkbox"/> FACILITIES/CAPITAL COSTS
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PREPARED BY:	DATE	REVIEWED BY:	DATE
PROGRAM APPROVED BY:			
DEPARTMENT DIRECTOR OF:	DATE	AGENCY REPRESENTATIVE:	DATE

Pending Approval

DOES THIS BCP CONTAIN INFORMATION TECHNOLOGY (IT) COMPONENTS? YES OR NO
IF YES, DEPARTMENTAL CHIEF INFORMATION SIGNATURE _____ DATE _____

FOR INFORMATION TECHNOLOGY REQUESTS, SPECIFY THE DATE SPECIAL PROJECT REPORT (SPR) OR FEASIBILITY STUDY REPORT (FSR) WAS APPROVED BY THE DEPARTMENT OF FINANCE.

DATE _____ PROJECT # _____ FSR OR SPR
IF PROPOSAL AFFECTS ANOTHER DEPARTMENT, DOES OTHER DEPARTMENT CONCUR WITH PROPOSAL? _____ N/A

YES NO ATTACH COMMENTS OF AFFECTED DEPARTMENT SIGNED AND DATED BY THE DEPARTMENT DIRECTOR OR DESIGNEE.

DEPARTMENT OF FINANCE ANALYST USE (ADDITIONAL REVIEW)

CAPITAL OUTLAY OTROS FSCU OSAE CALSTARS

DATE SUBMITTED TO THE LEGISLATURE: _____ PPBA: _____

FL # 3	DATE 02/13/2008	Title of Proposed Change: LLC Protective Claims - Processing Costs and Attorney Fees
PROGRAM Tax Programs	ELEMENT 20- Bank & Corp Tax	COMPONENT

	<u>Personnel Years</u>			<u>CY</u>	<u>BY</u>	<u>BY + 1</u>
	<u>CY</u>	<u>BY</u>	<u>BY + 1</u>			
Total Salaries & Wages a/	.0	3.0	3.0	\$ 0	\$ 115,000	\$ 115,000
Salary Savings	.0	-2	-2	\$ 0	-\$ 6,000	-\$ 6,000
Net Total Salaries and Wages	.0	2.8	2.8	\$ 0	\$ 109,000	\$ 109,000
Staff Benefits b/				\$ 0	\$ 52,000	\$ 52,000
Total Personal Services				\$ 0	\$ 161,000	\$ 161,000

Operating Expenses and Equipment

General Expenses /1		\$ 0	\$ 11,000	\$ 3,000
Printing		0	0	0
Communications /2		0	3,000	3,000
Postage		0	0	0
Travel-In-State		0	0	0
Travel Out-of-State		0	0	0
Training		0	0	0
Facilities Operations /3		0	1,000	1,000
Utilities		0	0	0
Cons & Prof Svs - Interdept'l		0	0	0
Cons & Prof Svs - External		0	0	0
Consolidated Data Center		0	0	0
Data Processing /4		0	2,000	1,000
Equipment		0	0	0
Other Items of Exp (Specify Below) /5		0	545,000	0
Total Operating Expense & Equipment		\$ 0	\$ 562,000	\$ 8,000

a/ Itemized detail on Page II-3 by classification as in Salaries and Wages Supplement.

b/ Detail provided on following pages.

- /1 General Expense @ \$813 per position. Plus minor equipment @ \$1116 per position. 4 PCs @ \$1260 per position.
- /2 Communication costs @ \$1136 per position.
- /3 Facilities Costs: incremental price increase \$374 per position.
- /4 Software for PCs @ \$485 per PC, \$180 on-going cost for PCs .
- /5 Attorney Fees (One-Time Cost).

				<u>CY</u>		<u>BY</u>		<u>BY + 1</u>	
TOTAL OPERATING EXPENSES AND EQUIPMENT				\$	0	\$	562,000	\$	8,000
SPECIAL ITEMS OF EXPENSE d/				\$	0	\$	0	\$	0
PROGRAM ADMINISTRATION				\$	0	\$	0	\$	0
Distributed Admin				\$	0	\$	0	\$	0
TOTAL STATE OPERATIONS EXPENDITURES				\$	0	\$	723,000	\$	169,000
<u>Source of Funds</u>		<u>Appropriation No.</u>							
	Org	-	Ref - Fund						
General Fund	1730		001 0001	\$	0	\$	723,000	\$	169,000
				0	0	0	0	0	0
				0	0	0	0	0	0
				0	0	0	0	0	0
				0	0	0	0	0	0
				0	0	0	0	0	0
Reimbursements	1730		501 0995	0	0	0	0	0	0
Totals				\$	0	\$	723,000	\$	169,000
LOCAL ASSISTANCE				\$(0)	\$(0)	\$(0)
<u>Source of Funds</u>		<u>Appropriation No.</u>							
	Org	-	Ref - Fund						
General Fund	1730		001 0001	\$	0	\$	0	\$	0
				0	0	0	0	0	0
				0	0	0	0	0	0
				0	0	0	0	0	0
				0	0	0	0	0	0
Reimbursements				0	0	0	0	0	0
Totals				\$	0	\$	0	\$	0

d/ Special Items of expense must be titled. Please refer to the Uniform Codes Manual for a list of the standardized Special Items of expense objects which may be used.

**DETAIL OF STAFF BENEFITS
AND PERSONAL SERVICES**

Positions		Positions			Salary Range	CY	Amount		
		CY	BY	BY + 1			BY	BY + 1	
Audit Division									
Tax Technician, Ftb - Rg B	LT - 2 YR	0.0	1.5	1.5	\$ 2,817 \$ 3,426	\$	0	\$ 56,000	\$ 56,000
Total Audit Division		.0	1.5	1.5		\$	0	\$ 56,000	\$ 56,000
Adjust for Part Year Positions		.0	.0	.0					
Net Positions/ PYs before salary savings		.0	1.5	1.5					
Filing Division									
Tax Program Tech II, Ftb	LT - 2 YR	0.0	1.5	1.5	\$ 2,950 \$ 3,588	\$	0	\$ 59,000	\$ 59,000
Total Filing Division		.0	1.5	1.5		\$	0	\$ 59,000	\$ 59,000
Adjust for Part Year Positions		.0	.0	.0					
Net Positions/ PYs before salary savings		.0	1.5	1.5					
Total Salaries and Wages									
	Positions	.0	3.0	3.0		\$	0	\$ 115,000	\$ 115,000
	Part Yr Adj	.0	.0	.0					
	P.Y.s	.0	3.0	3.0					

**Schedule of Staff Benefits Costs
FOR FISCAL YEAR 2008/09**

Staff Benefits	2007/08	2008/09	2009/10
OASDI /1	\$ 0	\$ 7,000	\$ 7,000
Dental /2	0	2,000	2,000
Health /3	0	22,000	22,000
Retirement /4	0	18,000	18,000
Vision /5	0	0	0
Medicare /6	0	2,000	2,000
Worker's Comp /7	0	1,000	1,000
Industrial Disability /8	0	0	0
Non Industrial Disability /9	0	0	0
Unemployment Insurance /10	0	0	0
Total Staff Benefits	\$ 0	\$ 52,000	\$ 52,000

- 1/ For permanent and overtime, 6.2% of net salary.
- 2/ For permanent, \$545 per net personnel year.
- 3/ For permanent, \$7,711 per net personnel year.
- 4/ For permanent, 16.633% of net salary.
- 5/ For permanent, \$110 per net personnel year.
- 6/ 1.45% of net salary for permanent.
- 7/ 0.8% of net salary for permanent.
- 8/ 0.05% of net salary for permanent.
- 9/ 0.21% of net salary for permanent.
- 10/ 5.68% of net salary for temporary help.

**FRANCHISE TAX BOARD
Fiscal Year 2008/2009**

Finance Letter

FL No.: #3

LLC Protective Claim - Processing and Attorney Fees

Date: February 15, 2008

A. Nature of Request

The Franchise Tax Board (FTB) requests an augmentation of \$723,000 and 3 two-year limited term positions (2.8 PYs) to pay potential attorney fee judgments and process refunds resulting from the January 31st decision by the Court of Appeal in *Northwest Energetic Services, LLC v. Franchise Tax Board*, and in anticipation of a Court of Appeal decision in *Ventas Finance I, LLC v. Franchise Tax Board*. This proposal would satisfy judgment for attorney fees and litigation costs awarded by the court in these cases. Also, this proposal would allow for refunds to be processed for LLCs that have no activities in California, as the Court has determined in *Northwest* that the LLC fee is a tax that is unconstitutionally applied on these entities.

B. Background/History

Under state law, a Limited Liability Company (LLC) not classified as a corporation must pay the annual LLC fee if it is organized, doing business, or registered in California. The annual LLC fee is based on the LLC total income from all sources reportable to the state. "Total Income" is defined as gross income from whatever source derived plus the cost of goods sold that are paid or incurred in connection with a trade or business; excluding the flow-through of income from one LLC to another LLC if that income has already been subject to California's annual LLC fee.

In *Northwest Energetic Services, LLC v. Franchise Tax Board*, and *Ventas Finance I, LLC v. Franchise Tax Board*, the San Francisco Superior Court held in its Statement of Decision that the LLC fee could not be applied constitutionally because the unapportioned tax on income violates the Commerce Clause of the United States Constitution and the Due Process Clauses of the California and United States Constitutions (see attachment 1). In the case of *Northwest*, the income was derived solely from sources outside of California. In the case of *Ventas*, the income was derived from sources within and outside California.

In the cases being cited, the LLC fee was determined to be unconstitutional because it is not fairly apportioned. A fundamental principle governing state taxation (grounded in the Due Process and Commerce Clauses) is that a state tax must be fairly apportioned; it must be calibrated to the level of activity in the state. The LLC fee is based on worldwide gross receipts rather than in-state activity. Further, adding an apportionment mechanism into the current statute would run contra to the Legislature's expressed intent. The legislative history establishes that the Legislature

considered and rejected apportionment.

FTB appealed these decisions in the California Court of Appeal, and continued to enforce the LLC fee requirement.

Attorneys' Fees - \$545,000

Attorneys' fees for these two cases may total up to \$545,000, or approximately \$325,000 for *Northwest* and \$220,000 for *Ventas*.

Northwest - \$325,000

The plaintiff's representatives in *Northwest* had sought attorneys' fees of approximately \$5 million based on the California Code of Civil Procedure¹ (CCP), also known as the Private Attorney General doctrine, that allows for the recovery of attorneys' fees in any action that has resulted in the enforcement of an important right affecting the public interest.

The FTB argued that the Revenue and Taxation Code² (R&TC) should exclusively control, as it provides that taxpayers may be entitled to recover costs incurred in pursuing litigation for tax refunds, including attorneys' fees, from the FTB. In essence, RTC provides relief for actual costs while CCP provides a method of relief multiplying actual costs, which can significantly increase an award of attorneys' fees.

The trial court awarded attorneys' fees of \$3.5 million in *Northwest*, which the FTB appealed.

In its January 31st decision in *Northwest*, the California Court of Appeal ruled for the plaintiff, but on the most limited grounds possible. The court held that the LLC fee is a tax and unconstitutional as applied to an LLC that has no activities in California because it fails the Commerce Clause requirement that it be fairly apportioned. This ruling only has significance for similar LLCs that do no business in California.

In the *Northwest* case, the California Court of Appeal also agreed with the trial court that the R&TC provision was not an exclusive remedy and that fees could be awarded under the CCP. However, the appellate court rejected the award of \$3.5 million, sustaining attorneys' fees of at least \$214,000, and remanding the case back to the trial court to determine if a "multiplier" should be applied to this amount. Based on the trial court's award in *Ventas*, it appears likely that a multiplier of 1.5 could be applied to the potential billed amount.

The decision of whether to appeal *Northwest* to the California Supreme Court is still under review.

¹ §1021.5

² §19717

Ventas - \$220,000

With regard to the *Ventas* case, plaintiff's representatives asked the court to award attorney fees of \$30 million based on the CCP. The FTB again argued that the RTC provision exclusively controls the allowance of attorney fees resulting from litigation of tax matters. The trial court awarded \$219,000 based on plaintiff's argument. Originally, both parties appealed this award, however, plaintiff subsequently withdrew its cross-appeal. It is expected that a court date will be set sometime in early 2008 with a decision thereafter.

As a result of these events, the FTB also is seeking legislation that would specify/clarify that attorney fees in tax refund lawsuits would be determined by the R&TC, and not the CCP. This legislation would be consistent with the original intent of the R&TC section. However, since legislation typically applies the January 1 after its enactment, this change should impact lawsuits filed on or after January 1, 2009, and would not impact these LLC cases.

Processing Costs - \$178,000

Taxpayers filed protective claims for refunds in anticipation of the court's decision in these cases, and also in the related case of *Bakersfield Mall LLC v. Franchise Tax Board*. These protective claims involve approximately 38,000 LLC accounts, 100,000 tax years, and with a value totaling approximately \$500 million. These claims were filed to protect their Statute of Limitation while awaiting the court's decision on these cases. FTB maintains a database for these protective claims.

The narrow ruling in *Northwest* has reduced the universe of LLCs that filed protective claims but will be entitled to a refund, as it impacts only LLCs that do no business in California. Based on this precedent, it is expected that the *Ventas* decision also will be narrow. While it is still early to determine a final number, it is estimated that from the total of protective claims mentioned above, the department will only have to process refunds for approximately 4,000 LLCs, involving 10,000 tax years, and a value of \$60,000,000.

C. State Level Considerations

Since the court has held that the LLC fee is unconstitutional for entities with no activities in California and ruled against FTB with regard to attorney fees, FTB and the State of California is obligated to satisfy judgment. For both the *Northwest* and the anticipated *Ventas* decision, it is estimated that \$60,000,000 will need to be refunded. The full amount of attorneys' fees is unknown until the trial court rehears *Northwest* and *Ventas* is decided, but is estimated to be no more than \$545,000.

D. Facility/Capital Outlay Considerations

The program area represented in this BCP has the space available to accommodate these additional staff, although some workstation alterations are necessary.

E. Justification

FTB's Strategic Plan includes two goals and associated strategies that directly support this request. The supporting goals and strategies are:

Strategic Goal #1: Improve Customer Service

- Improve the speed in which we process tax returns and handle exceptions, including claims for refund, tax returns, etc.

Strategic Goal #2: Increase Fairness and Compliance with Tax Law

- Provide fair and impartial treatment for every taxpayer.

In order to issue the appropriate refunds in a manner consistent with FTB's strategic goals listed above, new resources will be necessary. The additional resources will allow FTB to timely process these claim for refunds consistent with Strategic Goal #1 in a fair and impartial manner consistent with Strategic Goal #2.

F. Outcomes and Accountability

It is anticipated that the decision in *Ventas* will fall along the same lines as *Northwest*, and FTB will be obligated to comply with the court's decision and refund the appropriate fee to the LLCs within the acceptable timeframes. Timely processing of these claims fall under the direction of the Filing Division Chief. Ensuring that appropriate funds are available to pay support costs and attorney fee judgments is the responsibility of the Department's Chief Financial Officer.

G. Analysis of all Feasible Alternatives

Alternative #1 – Approve \$723,000 of funding and 3 two-year limited term positions

It is anticipated that the processing costs of \$178,000 to cover 3 two-year limited term positions will be needed to process refunds related to the issues decided in both the *Northwest* and *Ventas* claims, though this assumes that *Ventas* also will be narrowly decided. Also, that \$545,000 will be needed to cover attorney fees for both cases, though this amount may increase, depending on the "multiplier" applied by the trial court in *Northwest*, and the appellate court decision in *Ventas*.

Alternative #2 – No additional resources

Due to the sensitivity of this workload and the need to process the refunds, processing resources will be redirected to this workload. If no resources are received for this effort, FTB will need to evaluate other Filing Division processing workloads and prioritize according to the resources available. As a result, other critical workloads may not be processed timely causing further backlogs and delays. This impact could potentially affect FTB's compliance programs, customer service staff, and ultimately taxpayers. Furthermore, the State's revenue will be impacted due to the additional interest that will be paid on refunds as a result of the delayed processing of the protective claims and other return workloads.

Furthermore, FTB cannot absorb from its operational budget a \$545,000 judgment for attorney fees without an impact to FTB's revenue processes and the programs dependent on such revenue.

H. TIMETABLE

The funding is needed July 1, 2008.

I. RECOMMENDATION

Alternative #1 – Provide funding of \$723,000 and 3 two-year limited term positions.

This alternative provides for an additional \$723,000 of funding and 3 two-year limited term positions to issue timely refunds of \$60,000,000 for the approximate 10,000 tax years affected and to satisfy potential attorney fee judgments. It also saves the state money by preventing the payment of interest on the refunds that are not processed timely.

COMMERCE:

From **The Constitution of the United States, Article 1, Section 9, Clause 6:**

No Preference shall be given by any Regulation of Commerce or Revenue to the Ports of one State over those of another: nor shall Vessels bound to, or from, one State, be obliged to enter, clear, or pay Duties in another.

DUE PROCESS:

From **The Constitution of the United States, Amendment 14, Section 1:**

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law, which shall abridge the privileges or immunities of citizens of the United States, nor shall any State deprive any person of life, liberty, or property, without due process of law, nor deny to any person within its jurisdiction the equal protection of the laws.

From **The Constitution of the State of California, Article 1, Section 7:**

SEC. 7. (a) A person may not be deprived of life, liberty, or property without due process of law or denied equal protection of the laws; provided, that nothing contained herein or elsewhere in this Constitution imposes upon the State of California or any public entity, board, or official any obligations or responsibilities which exceed those imposed by the Equal Protection Clause of the 14th Amendment to the United States Constitution with respect to the use of pupil school assignment or pupil transportation.