In the course of transferring the processing of limited liability companies (LLCs) to the Business Entities Tax System (BETS), some technical questions have arisen. You request a technical advice memorandum to clarify some of these issues.

BACKGROUND

The Beverly-Killea Limited Liability Company Act of 1994 (Stats. 1994, Ch. 1200) authorized the formation of LLCs in California and recognized out-of-state LLCs doing business in California. The legislation also created three new taxes for LLCs classified as partnerships. The LLC annual tax (R&TC §17941), LLC annual fee (R&TC §17942), and the Nonconsenting Nonresident Members tax (NCNR) (R&TC §18633.5). The annual fee is treated like a tax for purposes of assessment, collection and penalties.

As a general rule, taxes on or measured by income are due and payable on the original due date of the tax return. (See R&TC §19001.) This includes the corporate minimum tax (R&TC §23153). Corporations are required to make estimated tax payments, and the first installment must be an amount at least equal to the minimum tax (R&TC §19024(a).) While a corporation must pay an amount equal to the minimum franchise tax as the first estimate installment in order to avoid an estimated tax penalty, for purposes of interest, penalties and statute of limitations, the minimum franchise tax is actually due and payable on the original due date of the tax return.

The LLC annual tax was set at an amount equal to the minimum franchise tax. (R&TC §17941(a).) Unlike the minimum franchise tax, however, LLC annual tax was made due and payable on the 15th day of the fourth month of the taxable year (i.e. the same date that the first estimated tax payment in the amount of the minimum franchise tax was due), instead of on the original due date of the LLC return. The annual fee and the NCNR tax are due on original due date of the LLC return. The creation of three taxes with two different due dates for one taxable year has created difficulties in applying existing statutes related to imposition of penalties and interest.

FTB has proposed legislative changes to conform the due date of the LLC tax to the original due date of the LLC return, but as yet, the changes have not been enacted. (See AB 190, currently pending.)
QUESTIONS

1. Billings for unpaid taxes, penalties and interest currently are made after the Form 568 is filed. Is this correct? Alternatively, should we bill the LLC annual tax, and related penalties and interest separately from billings for the LLC fee and/or NCNR tax, i.e., billing the LLC annual tax before the Form 568 is filed but after the LLC annual tax is due and payable?

Answer: Legally, there is no requirement that billing for a due and payable amount be done at any particular time. Therefore, it is not improper for billing to be done after the Form 568 is filed for the tax year at issue. It would also be permissible to bill the LLC annual tax after the due date of the LLC tax but before the Form 568 is due.

2. The LLC annual tax is due on the 15th day of the fourth month of the taxable year (R&TC 17941). If the payment is not timely we impose the failure to pay tax (FTP) penalty (R&TC 19132). We interpret the authority for the imposition of the penalty to be R&TC 19132 (a)(1)(D). This implies that the penalty is not subject to the 15 day grace period provided by R&TC 19132 (a)(1)(B). Is this interpretation correct?

Answer: Yes. The basic purpose of the FTP penalty is to penalize a taxpayer for not paying an amount the taxpayer knows or should have known is due. The 15-day rule of R&TC §19132(a)(1)(B) applies generally where an amount of tax is required to be shown on the return, but is not so shown, or the amount is corrected under math error procedures of §19051. In other words, where the taxpayer thought that the proper amount of tax was being paid, as a general rule the law allows a 15-day grace period for the taxpayer to respond to the adjustment notice without penalty. The LLC annual tax imposed by R&TC §17941 is covered by a specific provision (§19132 (a)(1)(D)) that does not have a grace period, and so the 15-day rule does not apply.

3. If the LLC fee and/or the NCNR tax is not paid by the original due date of the return, the FTP penalty is imposed under the authority of R&TC §19132(a)(1)(A) if the tax is shown on the return (self-assessed) but not paid. If the tax is NOT shown on the return, i.e., not self-assessed, and not paid, we impose the penalty under the authority of (R&TC §19132(a)(1)(B)), which provides for a 15 day grace period before penalties are imposed. Is this interpretation correct?

Answer: Yes. As explained above, the FTP penalty is essentially meant to discourage taxpayers from deliberately failing to pay an amount that they know is due. Where the unpaid amount is not shown on the return and is assessed by FTB by RIN, the 15-day grace period should apply. For self-assessed amounts shown on the return, the grace period should not apply.
4. Interest is imposed on any unpaid tax from the due date of the tax until the tax is paid. (R&TC §19101). Is this interpretation correct?

Answer: Yes. In the cases of the LLC Annual Tax, R&TC §17941(c) provides that the due date is the 15th day of the fourth month of the taxable year. So interest runs from that date on unpaid amounts.

5. The start date of the interest to be charged on the underpayment [Failure to Pay (FTP)] penalty (R&TC 19132(a)(2)(A)) is problematic. The LLC Interim Billing Program charged interest on the underpayment penalty from the due date of the tax. This was based on an interpretation that R&TC 19106(c) should be viewed in relation to R&TC 18567(b), that states that "An extension...is not an extension of time for payment of tax required to be paid on or before the due date of the return without regard to extension. Underpayment of tax penalties shall be imposed as provided by law without regard to any extension granted under this section." Also, the form 3522, LLC Tax Voucher, was viewed as a "return" to report the LLC annual tax assessed by R&TC 17941, i.e., not "self-assessed" on a return.

This interpretation reflects the intent of the federal legislation, the source of R&TC 19106, and was enacted by the Deficit Reduction Act of 1984. To quote from the Senate Finance Committee explanation of provisions, "An interest element running from the due date of the return should be added to these penalties to increase their efficacy. Specifically, the committee does not believe that a taxpayer who delays resolution of his case should be subject to a lighter penalty (by reason of the time value of money) than a taxpayer who settles his case promptly".

A literal reading of 19106(c), and assuming that form 3522 is NOT a return, might lead to a conclusion that interest on the underpayment penalty would begin on the (1) the original due date for returns (Form 568) filed on or before the original due date, and delinquent returns, or (2) the extended due date for returns (Form 568) filed after the original due date and on or before the extended due date.

What is the correct date to begin charging interest on the underpayment penalty?

Answer: R&TC §19741 requires the payment of the LLC annual tax, but does not require the filing of a "return" with respect to that tax. Form 3522 is a payment voucher, and does not meet the normal definition of a "return." R&TC §18633.5 defines and sets forth the requirements for LLC returns of income.

Although the phrase "return of the tax" in section 19106 (c) does not clearly refer to the "return of income" described in section 18633.5, the Form 568 return of income is what is commonly understood to be the "return" for LLCs. Therefore, interest should not begin to accrue on the FTP penalty before the due date (as extended) of the Form 568, with
interest on the penalty beginning on the extended due date of the return, while interest on
the annual tax begins on the payment due date, as does the monthly penalty.

Although this seems to be an anomalous result, had the drafters of the legislation wished
to provide for a different interest starting date for a penalty that arises from a tax due
before the return for the year, they could have done so. I should point out that a similar
situation occurs where an individual or corporate tax return is filed after the original due
date but on or before the extended due date. Interest on the tax and the FTP monthly
penalty computed on that tax year runs from the original due date, while interest on the
FTP penalty does not begin until the extended due date.

6. If form 3522 is determined to be a "return" for purposes of R&TC 19106(c), would it
be a "return" for purposes of R&TC 19131, the delinquent penalty? How would the
penalty be applied?

Answer: Form 3522 is not a "return" as explained above, so no delinquent penalty arises.

7. R&TC 18633.5(e) imposes the NCNR tax. This indicates that if the LLC doesn't
secure the consenting signature of its nonresident members the LLC is subject to a
tax "on behalf of each nonresident...at the highest marginal tax rates..." R&TC
18633.5(g) states, "Any amount paid by the limited liability company to this state
pursuant to paragraph (1) of subdivision (e) shall be considered to be a payment by a
member on account of the income tax imposed by this state on the member for the
taxable period." If a Form 568 return is filed [specifically indicating that] payment is
[being] made on behalf of the NCNR members, but no payments have been made for
the LLC annual tax and the LLC annual fee, how should the payment of NCNR tax be
applied?

The proposed application hierarchy is:

1st- NCNR tax and LLC fee
2nd- LLC annual tax
3rd- Interest bearing penalties
4th- Interest
5th- Non interest bearing penalties

Is this interpretation correct?

Answer: As in the answer to Question #1, FTB has discretion to apply payments in any
manner. As a general policy, FTB will apply payments as directed by the taxpayer, then
apply undesignated payments according to procedures that generally operate to reduce
total interest and penalties payable and pay off balances due for earlier tax years. (See,
In the example above, assuming that the taxpayer specifically directed the amounts shown on the return to be applied to the amounts due with the return, i.e., the NCNR and then the LLC fee, the hierarchy appropriately applies the payment as directed to the NCNR tax and the LLC fee shown on the return first. The remaining hierarchy, applying payments to tax, penalties, interest, and non-interest bearing penalties is permissible as within FTB’s discretion.

8. What rates for NCNR tax should be applied if the NCNR member is a partnership, LLC taxed as a partnership, or an S corporation?

Answer: R&TC §18633.5(e)(1) requires the NCNR tax to be computed as an amount equal to the highest marginal tax rate in effect under §17041, in the case of members which are individuals, estates or trusts, and §23151 in the case of members which are corporations. Under §23802(b)(1) the tax imposed under §23151 shall be imposed at the rate of 1½% for S corporations. FTB’s Form 568 Instructions for Schedule T requires use of the 9.3% individual rate for partnerships and LLCs taxed as partnerships. (In general, the taxable income of a partnership is determined in the same manner as in the case of an individual.) This is also consistent with the underlying policy of the section, which is that the highest marginal tax rate is used to ensure that the tax will not be less than the maximum possible tax that could be due had the LLC member consented.

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