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I Want a Refund: The Inadequate Opinion of Northwest Energetic Services, LLC v. California Franchise Tax Board

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NOTE
I WANT A REFUND: THE INADEQUATE OPINION OF NORTHWEST ENERGETIC SERVICES, LLC
V. CALIFORNIA FRANCHISE TAX BOARD

The California Franchise Tax Board has received numerous
claims for refunds from LLCs based on two cases that found a levy
charged to LLCs registered in California unconstitutional because
it was not fairly apportioned. The court in Northwest Energetic
Services, LLC v. California Franchise Tax Board held that the
levy required by section 17942 of the California Revenue and
Taxation Code violated the Commerce Clause and was therefore
unconstitutional. The court in Ventas Finance I, LLC v.
California Franchise Tax Board agreed and added that LLCs are
only entitled to a refund of “payments exceeding fairly
apportioned assessments for years in issue.” Currently, only the
Northwest decision is final, and LLCs may take action in claiming
refunds under the decision.

In Northwest Energetic Services, LLC v. California Franchise
Tax Board, the California Court of Appeal affirmed Northwest
Energetic Services, LLC’s (“NES”) suit against the
constitutionality of a levy imposed by the California Franchise
Tax Board (“FTB”) for limited liability companies (“LLC”)
registered in California. In making its decision, the Appellate Court focused on the levy’s reference to “total income,” which the Appellate Court determined was income “wherever earned, and without apportionment according to the percentage of business or income attributable to activities within the state.”

This Note closely examines the reasoning behind the Northwest decision, while arguing that parts of the decision are extraneous and the essential question of the meaning of section 17942 is examined in a cursory and incomplete manner by the court. Part I approaches the Northwest court’s decision with background information of the Commerce Clause and the LLC Act discussed in the court’s analysis. Part II lays out in detail the facts of the Northwest case and the court’s opinion. Part III analyzes the court’s seemingly systematic discussion of the case, and argues that the court failed to thoroughly consider the explicit wording of section 17942. An alternative approach to the LLC Act, examining the allegedly unconstitutional levy provision on its face, is suggested. Part IV further argues that the benefits of this alternative approach are supported by the Ventas case as the court essentially desired to apportion the levy anyway. This discussion may be useful to proponents of the FTB and practitioners involved in the possible appeal of the Ventas case.

I. Background Information

`Id. at 853.`
A. What is Allegedly Being Violated: The Commerce Clause

Article I, section 8, clause 3 of the United States Constitution gives Congress the power to “regulate commerce … among the several states.” Although the Commerce Clause is considered “a grant of power to Congress and not an express limitation on the power of states,” the dormant implication of this clause prohibits state taxes that discriminate against or unduly burden interstate commerce. Courts have held that state laws discriminating against interstate commerce are virtually per se invalid. This prohibition against discriminatory state taxes applies even when Congress has failed to legislate on a subject.

The purpose of the dormant Commerce Clause is said to be the protection of markets and participants in markets, rather than taxpayers. Because the Commerce Clause seeks to prevent state taxes from impeding free private trade in the national marketplace, states are prohibited from taxing value earned outside of its borders.

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7 U.S. CONST. art. I, § 8, cl. 3.
11 71 AM. JUR. 2d. § 175 Constitutional restrictions, generally (2008).
Tests for determining whether a state law violated the Commerce Clause were put forward by two United States Supreme Court cases: *Complete Auto Transit, Inc. v. Brady* and *Pike v. Bruce Church, Inc.* The tests are explained in detail in Part II.


The Beverly-Killea LLC Act was enacted in 1994 to allow for the first time “the formation, operation, and regulation of LLC’s within California.” Before the LLC Act, business entities could only form in California as corporations, partnerships, or sole proprietorships. LLC’s are hybrid entities combining favorable provisions of tax law associated with partnerships, with favorable provisions of liability law associated with corporations. Thus, the LLC provides advantages over certain partnerships and corporations.

An LLC is formed by two or more people who file articles of organization with the Secretary of State and execute an operating agreement between the members. LLC’s are treated as partnerships and thus are not subject to the 9.3 percent corporation tax at the entity level.

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15 *Id.*
17 *Id.*
California noticed the growing popularity of LLC’s and enacted the LLC Act for the purpose of expanding California’s competitive business environment. Senate Bill 469, proposing the LLC Act, explicitly took into consideration the fact that at least 35 other states had laws authorizing some sort of LLC. The LLC Act required that LLC’s organized in these other states had to register with the Secretary of State in order to do business within California.

Additionally, Senate Bill 469 stated that the FTB would be required to study, and if necessary, “adjust fees (assessed LLC’s) to ensure ‘revenue neutrality.’” The FTB projected that state tax revenues totaling approximately $690 million for a five-year period would be lost due to more entities becoming LLC’s instead of corporations and thereby avoiding the entity-level tax. Thus, sections 17941 and 17942 of the LLC Act were added to make the legislation more “revenue neutral.” Section 17941 required a minimum LLC tax of $800, while section 17942 added an extra fee based on the LLC’s total income.

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19 Northwest, 159 Cal.App.4th at 852.
21 See Id.
22 Northwest, 159 Cal.App.4th at 852.
23 Id.
24 Id. at 855.
25 California Revenue and Taxation Code §§ 17941, 17942; Section 17941 essentially provides that an annual minimum tax must be paid by LLCs doing business in California or having had its articles of incorporation accepted or certificate of registration issued by the Secretary of State. (Northwest, 159 Cal.App.4th at 853). Former section 17942 stated: “In addition to the tax imposed under Section 17941, every limited liability company subject to tax under Section 17941 shall pay annually to this state a fee equal to” specified amounts determined by “the total income from all sources reportable to this state for the taxable year.” Subsection (b)(1) further stated that “total income” is defined as “gross income, as defined in Section 24271, plus the
17942 tax was to range from $0 to $4500 for the taxable year depending on the total income of the LLC. An LLC with a total income of less than $250,000 was not required to pay any fees. However, an LLC with a total income in excess of $5 million had to pay a flat fee of $4,000 in 1994 and 1995. 

II. The Northwest case: Facts, Procedural History, and Opinion

A. Facts

NES was a limited liability company, engaged in the business of selling and servicing explosives, organized under the laws of the state of Washington. Although it only conducted business with customers in Washington, Montana, Oregon, and Idaho, it also registered as a limited liability company with the California Secretary of State in June of 1997 and maintained the certificate of registration for five years. California’s LLC Act required that LLCs registered with the state pay a minimum tax imposed under section 17941 and an additional amount under cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer.”


Northwest, 159 Cal.App.4th at 849.

NES had no operations, property, inventory, employees, agents, independent contractors or place of business in California. Additionally, NES did not solicit or make deliveries to customers in California.

Northwest, 159 Cal.App.4th at 849. It is unknown from the record exactly why NES registered as an LLC in California. However, a plausible reason may be that it intended to do business in California in the future. (See Appellants Opening Brief at 9, Northwest Energetic Services, LLC v. California Franchise Tax Bd., 2007 WL 1480097 (2007).

California Revenue and Taxation Code § 17000 is known as the Beverly-Killea Act
section 17942 based on “total income from all sources reportable to [the] state for the taxable year.” The FTB thus notified NES that it owed $27,458.13 under the section 17942 levy for the tax years of 1997, 1999, 2000, and 2001. NES paid the amount and then cancelled its registration with the Secretary of State on June 13, 2002. NES filed a claim with the FTB for a refund of the amount paid, but was denied. After subsequently being denied a refund by the State Board of Equalization, NES filed suit in January 2005 against the FTB a refund of the full amount paid under the section 17942 levy. NES argued that because section 17942 included no method for apportioning the levy according to the amount of income earned within the state, it was discriminatory against interstate commerce and thus violated the Constitution.

B. Procedural History

In the decision dated April 13, 2006, the San Francisco County Superior Court agreed with NES, holding that the levy violated the Commerce Clause of the United States Constitution and that NES was therefore entitled to a refund of the full

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32 Id.; Appellants Opening Brief at 5, Northwest Energetic Services, LLC v. California Franchise Tax Bd., 2007 WL 1480097 (2007). NES paid no LLC fees for the 2008 calendar year, and thus NES did not pursue a refund for that year.
33 Id.
34 Id.
35 Id.
36 Id.
amount paid.\textsuperscript{37} In July 2006, the FTB appealed the judgment to the California Appellate Court.\textsuperscript{38}

In the California Court of Appeal for the First District, the FTB argued that the California Legislature enacted section 17942 pursuant to its police power to impose regulatory fees on entities seeking the benefits and protections of LLCs in California.\textsuperscript{39} The FTB further argued that the levy did not violate the Commerce Clause because it satisfied the first, third and fourth prongs of the \textit{Complete Auto} test,\textsuperscript{40} and that NES failed to show that the levy was not fairly apportioned.\textsuperscript{41} In addition, the FTB also argued that the levy was a "fee" and not a "tax" subject to the \textit{Complete Auto} test.\textsuperscript{42} Thus, the FTB contended that, as a fee subject to the balancing test laid out in \textit{Pike}, the levy was valid.\textsuperscript{43}

NES argued that the levy was indeed a tax because its sole purpose was to raise revenue for general governmental expenses.\textsuperscript{44} Additionally, NES argued that even if it were a fee, it would still be unconstitutional under the \textit{Pike} test.\textsuperscript{45}

\textsuperscript{37}Id. at 850. \\
\textsuperscript{38}Id. \\
\textsuperscript{39}Appellants Opening Brief at 9, Northwest Energetic Services, LLC v. California Franchise Tax Bd., 2007 WL 1480097 (2007). \\
\textsuperscript{40}Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). \\
\textsuperscript{41}Appellants Opening Brief at 22, Northwest Energetic Services, LLC v. California Franchise Tax Bd., 2007 WL 1480097 (2007). \\
\textsuperscript{42}Appellants Opening Brief at 20, Northwest Energetic Services, LLC v. California Franchise Tax Bd., 2007 WL 1480097 (2007). \\
\textsuperscript{43}Northwest, 159 Cal.App.4th at 864; \textit{Pike} v. Bruce Church, Inc. 397 U.S. 137 (1970). \\
\textsuperscript{44}Respondent's Brief at 14, Northwest Energetic Services, LLC v. California Franchise Tax Bd., 2007 WL 2485445 (2007). \\
C. Opinion

The California Court of Appeal for the First District held that the levy required by section 17942 of the California Revenue and Taxation Code violated the Commerce Clause and was therefore unconstitutional. The court took a systematic approach in examining the levy by first considering if it was a “fee” or a “tax.” After concluding that the levy more closely resembled a tax, the court subjected the levy to the constitutional tests under Complete Auto and Pike, and found that it failed to meet the requirements of both tests.46

1. The Tax-Fee Distinction

After an independent review of the record, the California Appellate Court found it best to decide, de novo, whether the section 17942 levy was a “tax” or a “fee” at the beginning of its analysis.47 First, the court looked to the enactment of section 17942 to determine whether its purpose closer resembled that of a fee or a tax. The court explained that the levy was enacted in 1994 as part of the Beverly-Killea Limited Liability Company Act, which for the first time authorized the formation and operation of LLC’s in California.48 Thus, the court explained, the LLC Act

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47 Id. at 851. The Appellate Court explained that its determination about the levy would only apply in the context of the present case.
48 Id. at 852.
was enacted to “[expand] California’s competitive business environment.”\textsuperscript{49} Next, the court laid out its understanding of the distinction between a “tax” and a “fee.” The court explained that a tax “raises revenue for general governmental purposes and is ‘compulsory rather than imposed in response to a voluntary decision... to seek ... benefits.’”\textsuperscript{50} A fee, according to the court, “funds a regulatory program or compensates for services or benefits provided by the government.”\textsuperscript{51} From here, the court closely examined the levy’s legislative history,\textsuperscript{52} finding that its purpose was to raise revenue to make up for the loss of tax that would be collected if companies formed as LLCs instead of corporations.\textsuperscript{53} The court explained that the California Legislature therefore added a minimum tax under section 17941\textsuperscript{54} and the 17942 levy to make the LLC Act “revenue neutral.”\textsuperscript{55} Additionally, the court added that the proceeds from the levy were deposited in the state’s general fund for general governmental purposes, and the FTB was authorized to administer the funds according to provisions governing the state’s income taxes.\textsuperscript{56} Considering its findings, the court stated that a substantial connection between the levy and any regulatory
\begin{footnotesize}
\textsuperscript{49}Id.
\textsuperscript{50}Id. at 854 (citing Sinclair Paint, 64 Cal.Rptr.2d 447).
\textsuperscript{51}Id.
\textsuperscript{53}Northwest, 159 Cal.App.4th at 855. During this time, C-corporations and S-Corporations were taxed at 9.3 percent and 1.5 percent respectively, while an LLC would not be taxed as an entity on net income. The FTB projected that the state would lose approximately $690 million without any revenue derived from the LLC Act.
\textsuperscript{54}Corp.Code § 17941. This provision of the LLC Act requires that LLC’s pay a minimum tax of $800.00 in addition to the § 17942 levy.
\textsuperscript{55}159 Cal.App.4th at 855.
\textsuperscript{56}Id. at 857.
\end{footnotesize}
program was lacking, and that the LLC Act itself did not qualify as a regulatory program. The FTB’s argument that the levy was a fee for the benefits LLCs gained from registering with the state was also rejected by the court. The court explained that nothing in the levy’s legislative history showed that a fee was required for the state to provide the benefits it offered to LLCs. Thus, the court concluded that the levy was to be considered a tax.

2. Testing the Levy’s Constitutionality under Complete Auto
   a. Background of Law. Complete Auto Transit, Inc. v. Brady involved a Michigan corporation (“Complete Auto Transit, Inc.”) that was engaged in the business of transporting motor vehicles by motor carrier for the automobile manufacturer, General Motors Corporation. General Motors manufactured the vehicles outside of Mississippi, and then shipped them by train to Jackson, Mississippi. The vehicles would then be loaded onto Complete Auto’s transportation truck for delivery to dealers within the state.

   The Mississippi Tax Commission assessed Complete Auto taxes totaling $122,160.59 for a three-year period of selling its transportation services. Complete Auto reluctantly paid the

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57 Id.
58 Id. at 859.
59 Id.
61 Id.
62 Id.
63 Id. The taxes were assessed pursuant to the current section 27-65-19(2) of the Mississippi Code: “Upon every person operating a pipeline, railroad, airplane, bus, truck, or any other transportation business for the
taxes but argued that its services were “part of a movement in interstate commerce,” and that the taxes assessed were unconstitutional because they were applied to operations in interstate commerce. The Mississippi Tax Commission, on the other hand, argued that the transportation was intrastate business, and that the tax was not unconstitutional even if the transportation were considered as part of interstate commerce.

Assuming that the transportation was interstate commerce, the United States Supreme Court held that the tax did not violate the Constitution. The Supreme Court explained that “the mere act of carrying on business in interstate commerce does not exempt a corporation from state taxation.” Instead, the Court subjected the Mississippi tax to a practical analysis in a four prong test. Under this test, a state tax does not violate the Commerce Clause if it satisfies the following requirements: (1) it is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, (4) and is fairly related to the services provided by the State. Because the Mississippi tax met these requirements, it was upheld by the Supreme Court.

transportation of persons or property for compensation or hire between points within this State, there is hereby levied, assessed, and shall be collected, a tax equal to five per cent of the gross income of such business …”

Id. at 276-77.

Id. at 276.

Id. at 287. The United States Supreme Court assumed that the transportation was interstate commerce because the lower Mississippi courts had made that assumption in their decisions.

Id. at 288.

See id. at 279, 287.
b. But what is “Apportionment”? Fair apportionment is required by second prong of the Complete Auto constitutionality test. In testing the constitutionality of a state tax, the Northwest court explained that fair apportionment requires both internal and external consistency. The requirement of internal consistency is met when “the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear.” In other words, the tax should not burden interstate commerce any more than it does intrastate commerce. The requirement of external consistency looks “to the economic justification for the State’s claim upon the value taxed, to discover whether a State’s tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State.” This essentially means that a state should not tax economic activity beyond its borders.

c. The Law Applied in Northwest. In considering the central question of whether the levy was unconstitutional, the Northwest court explained that the Commerce Clause of the Constitution prohibited state taxes that “[discriminate] against or unduly burden interstate commerce.” The court then analyzed the levy according to the constitutionality test laid out in Complete

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71 Id. at 863.
72 Id. at 861 (quoting Gen. Motors Corp. v. Tracy, 519 U.S. 278, 287 (1997); U.S. CONST. art. I, § 8, cl. 3. This section of the Constitution is often referred to as the “dormant Commerce Clause.” Oklahoma Tax Comm’n v. Jefferson Lines, Inc., 514 U.S. 175, 179 (1995).
The court focused on the test’s second prong of fair apportionment as this was what NES brought to issue.

Examining the levy against the internal consistency requirements, the court explained that if the levy were enacted by every state, LLC’s doing business with multiple states would be subject to the tax multiple times, whereas those confining their business to only one state would only be subject to the levy once. Thus, interstate commerce would be more burdened than intrastate commerce and violate internal consistency.

The court then looked to the test of external consistency. The court concisely explained that the levy did not meet the external consistency requirement because it was measured by an LLC’s “total income wherever earned,” and not limited to the amount fairly attributable to economic activity California.

3. The Levy’s Constitutionality under Pike

a. Background of Law. Pike v. Bruce Church, Inc. involved a company (“Bruce Church, Inc.”) engaged in the business of growing and packing fruits and vegetables in various locations in California and Arizona. At issue in this case was Bruce Church’s harvesting of a large cantaloupe crop in Parker, Arizona.

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73 Id. at 862 (citing Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)).
74 Id. The levy imposed a fee dependent on an LLC’s total unapportioned income.
75 Id. at 864.
76 Pike v. Bruce Church, Inc. 397 U.S. 137, 139 (1970).
Bruce Church was charged with violating the Arizona Fruit and Vegetable Standardization Act. A provision of the Act required that cantaloupes grown in Arizona and offered for sale had to be packed in containers approved by the supervisor. Under this provision, Bruce Church was prohibited from transporting uncrated cantaloupes from Arizona to nearby California.

The United States Supreme Court ruled in favor of Bruce Church, holding that the Arizona Fruit and Vegetable Standardization Act violated the Commerce Clause and was therefore unconstitutional. In doing so, the Supreme Court subjected the Act to a three prong balancing test. Under this test, a state statute has to meet the following requirements: (1) the statute regulates evenhandedly to effectuate a legitimate local public interest; (2) its effects on interstate commerce are only incidental; and (3) the burden imposed on such commerce is not clearly excessive in relation to the putative local benefits. In applying this test, the Supreme Court considered the purpose of the concerned provision, which was to ensure that fruits and vegetables shipped from Arizona met standards of quality and were not inferior or deceptively packaged. The Court reasoned that the Arizona’s interest was minimal in this case, as Bruce Church’s cantaloupes were of exceptional quality and were

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77 Id. at 138.
78 Id.
79 Id.
80 Id. at 142.
81 Id. at 143.
not identified as Arizona cantaloupes when shipped.\textsuperscript{82} This minimal state interest could not outweigh the $200,000 Bruce Church would have to spend to pack the cantaloupes in Arizona.\textsuperscript{83}

b. The Law Applied in Northwest. Entertaining the FTB’s argument that the levy would be valid under the balancing test of \textit{Pike}, the Northwest court stated that \textit{Pike} was inapposite to the present case because it did not concern a monetary fee, but rather a regulation on the manner of packing cantaloupes grown in a certain state.\textsuperscript{84} Here, the court also explained that cases involving fees and taxes alike were subjected to the fair apportionment requirement, and thus the distinction was of little importance.\textsuperscript{85} Nevertheless, the court subjected the levy to the \textit{Pike} test which required that (1) the statute regulates evenhandedly to effectuate a legitimate local public interest; (2) its effects on interstate commerce are only incidental; and (3) the burden imposed on such commerce is not clearly excessive in relation to the putative local benefits.\textsuperscript{86}

Focusing on the third prong of the test, the court stated that the levy imposed a burden on interstate commerce that was clearly excessive compared to the local benefits afforded by it.\textsuperscript{87} Here, the court again returned to its argument that there were no indications that the levy actually funded the LLC Act and the

\textsuperscript{82}Id. at 144.
\textsuperscript{83}Id. at 145.
\textsuperscript{84}Northwest, 159 Cal.App.4th at 865; \textit{Pike} v. Bruce Church, Inc. 397 U.S. 137 (1970).
\textsuperscript{85}Id.; Am. Trucking Assns., Inc. v. Schiener, 483 U.S. 266 (1987) (applying the internal consistency test to both a fee and tax).
\textsuperscript{86}Id. (citing \textit{Pike} v. Bruce Church, Inc. 397 U.S. 137 (1970)).
\textsuperscript{87}Id.
benefits it affords. Thus, the court found the levy unconstitutional under both the Complete Auto and Pike tests. Interestingly though, the court stated that only the portion of the levy that exceeded the Commerce Clause limits were to be refunded.  

III. Analysis

The California Court of Appeal ultimately concluded that the levy imposed by section 17942 violated the Commerce Clause and was unconstitutional. However, a substantial portion of the court’s opinion consisted of distinguishing the levy as a tax, and analyzing the levy under the test for constitutionality under Pike, neither of which was necessary in reaching the court’s conclusion. In effect, the court’s ruling relied entirely on the fact that the levy failed to meet the fair apportionment prong of the constitutionality test under Complete Auto. Thus, the court devoted much time to extraneous discussion. As a result of the efforts wasted on unnecessary discussion, the essential issue of the meaning of section 17942 was incompletely examined. A more thorough analysis should instead have closer examined the face of the statute, taking into consideration the explicit wording used.

A. The Unnecessary Tax-Fee Distinction

"Id. at 867."
The California Appellate Court followed precedent and the general trend of California courts in disregarding the FTB’s argument over the tax-fee distinction. California courts generally agree that the distinction is “frequently blurred,” and the two words take on different meanings in different contexts. However, while acknowledging that the distinction between taxes and fees does not make a difference for Commerce Clause purposes, the court still provided a lengthy discussion on the distinction. This decision by the court reflects upon its overall approach to the case, which is cursory.

First and foremost, one must question why the court would go through the effort of classifying the levy as a tax while acknowledging the distinction’s insignificance. The court stated that it felt that a consideration of the distinction was necessary de novo upon an independent review of the record, and “for clarity of [its] analysis and in light of FTB’s further contention that a different constitutional test, [namely Pike], applies to fees.” However, the court held that the Pike test applied to neither taxes nor fees, and that both taxes and fees were subject to the apportionment requirement in Complete Auto. This, in turn, makes the discussion of the tax-fee distinction of little importance in the court’s decision. In actuality, the

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81Id. at 851.
discussion provided minimal clarity into the court’s overall analysis of the case because it had no application to either test of constitutionality. Rather, this portion of the court’s opinion illustrates the court’s misdirected efforts.

Instead of giving deference to the FTB’s position that the section 17942 levy was indeed a fee, the court conducted an in-depth analysis of Senate Bill 469 and decided that it more resembled a tax.³³ The court’s engaging in the tax-fee distinction may have been reasonable had it made a difference in the court’s decision. However, in this case it did not.

Additionally, in the court’s discussion of the tax-fee distinction, the court virtually ignored the explicit language of the statute in section 17942, which stated that the levy was a “fee.”³⁴ The court considered the words of the statute only briefly and quickly turned to the purpose of the levy.³⁵ The court stated that although the levy was called a “fee,” “the statutory language does not indicate whether the Levy is imposed for purposes of raising general governmental revenue, for funding benefits and services (tax), or for funding a regulatory provision (fee).”³⁶ By this, the court essentially explained that the use of the word “fee” provided no insight into whether the levy was a fee or a tax and was insignificant in the analysis.

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³⁴California Revenue and Taxation Code § 17942 (“… shall pay annually to this state a fee equal to …” (emphasis added)).
³⁵Northwest, 159 Cal.App.4th at 854.
³⁶See Id.
The court’s analysis was thus wholly beyond the face of the statute and completely disregarded the importance of words used in statutes.\(^9\) If nothing more, the court’s tax-fee discussion foreshadowed cursory analysis that would be used in considering the levy’s constitutionality.

B. The Unnecessary Pike Test

In its constitutional analysis of the levy the court chose to subject the levy to tests under both Complete Auto and Pike. After explaining that Pike concerned a regulation on the manner of packing cantaloupes and was inapplicable to a taxes or fees, the court still continued its opinion by arguably finding the levy invalid under the stated test.\(^9\) The court set out these three prongs of the Pike test, but, in effect, only focused on the second and third prongs.\(^9\)

Unsure of how to interpret the first prong, the court proceeded directly to the second, stating that the levy’s impact on interstate commerce was not incidental. Here, the court baldly


\(^9\)Under Pike, a statute must meet the following requirements: (1) the statute regulates evenhandedly to effectuate a legitimate local public interest; (2) its effects on interstate commerce are only incidental; and (3) the burden imposed on such commerce is not clearly excessive in relation to the putative local benefits. Pike, 397 U.S. 137, 142 (1970).

\(^9\)Northwest, 159 Cal.App.4th at 865.
asserted that “0.2 percent of [NES’] total income” may not be considered incidental.\(^{100}\) The records show that this amount was $27,458.13.\(^{101}\) Although this is a large sum in some respects, it is only a fraction of $200,000, which the Pike court suggested was incidental.\(^{102}\) The Northwest court explained that the amount charged to NES was not incidental because no authority supports that such a cost is a “constitutionally permissible increase in the cost of interstate commerce.”\(^{103}\) This reasoning appears circular in that the purpose of the Pike test is to determine the constitutionality of the levy. To suggest that the second prong of the constitutionality test requires there to be authority supporting the levy’s constitutionality would essentially mean that any levy not already known to be constitutional is declared unconstitutional. Alternatively, a more reasonable approach to the second prong is taken by the Pike court. The court in Pike found the Arizona statute to be incidental in that its effects on interstate commerce were not imposed “on an entire industry.”\(^{104}\) Had the Northwest court followed this reasoning, it likely would have found the section 17942 levy to be incidental because it did not affect an entire industry.

In a similar fashion, the Northwest court failed to appropriately apply the third prong under Pike. In considering

\(^{100}\) Id.
\(^{101}\) Id.
\(^{102}\) See Pike, 397 U.S. at 146 (“Such an incidental consequence of a regulatory scheme could perhaps be tolerated if a more compelling state interest were involved.” (emphasis added)).
\(^{103}\) Id.
\(^{104}\) See Northwest, 159 Cal.App.4th at 865.
the third prong, the court stated that the burden imposed on interstate commerce by the levy is “clearly excessive in relation to local benefits.”\textsuperscript{105} In support, the court explained that NES received “no benefits, since it did not transact any business in California.”\textsuperscript{106} Here, the court’s effort is misplaced due to its lack of attention to the language of the Pike test. The court interprets “local benefits” to refer to benefits gained by NES in the taxing state. However, the first prong of the test uses the words “local public interest” to refer to the taxing state’s public interest, and not the taxpayer. Thus, the third Pike prong similarly seems to require the consideration of California’s local benefits, rather than NES’ benefits as emphasized by the court. This disparity is evident in the Pike court’s consideration of Arizona’s interest in preserving its reputation for having quality fruits and vegetables was outweighed by the roughly $200,000 the fruit company would have to spend to build a packing shed within the state.\textsuperscript{107} Unlike the Northwest court, the Pike court weighed the effect on interstate commerce, specifically $200,000, against the local benefits of the state. Had the Northwest court followed Pike’s approach, it could have considered in its balancing test the extent of the benefits, such as an improved business environment, gained by California from the levy.

\textsuperscript{105} Id.
\textsuperscript{106} Id.
\textsuperscript{107} Pike, 397 U.S. at 144.
Thus, the court’s analysis under Pike was not only unnecessary, but lacking in many respects.

C. The Court’s Analysis in a Nutshell: The Test Under Complete Auto

As explained in the preceding two sections, the Northwest court clearly stated that the tax-fee distinction did not make a difference for Commerce Clause purposes, and that Pike was inapplicable to the present case. Thus, the court’s analysis of the section 17942 levy under Complete Auto was essentially all that was necessary for the court to reach its decision in the case.

In its analysis, the court only focused on the second prong of the constitutionality test requiring fair apportionment because NES did not argue that the levy failed any of the other prongs. 108 The court correctly applied the internal consistency and external consistency tests as required under second prong of the test requiring the levy to be “fairly apportioned.” 109 However, after providing lengthy discussion on the tax-fee distinction and the Pike test, the court failed to adequately consider the crucial issue of apportionment.

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108 Northwest, 159 Cal.App.4th at 862. Under Complete Auto, a state tax must meet the following requirements: (1) it is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, (4) and is fairly related to the services provided by the State.

1. The Missing Discussion

In considering whether the levy was fairly apportioned, the court disregarded language in the statute which read that the section 17942 levy based on “total income” was to be from “all sources reportable to this state, [California], for the taxable year.” By the language of the statute, it appears as though “reportable to this state for the taxable year,” suggested apportionment in calculating total income. However, the court chose to give little weight to this language and instead looked to the FTB’s 1997 Form 568 booklet. The “Form 568” booklet stated that “total income” meant “income before taking into consideration any apportionment and allocation.” Additionally, the court looked to section 17942(b)(1) which directed to section 24271 in defining total income as “gross income” under section 61 of the Internal Revenue Code.

The problem here is that the court’s interpretation of section 17942 ended with “gross income” under section 61 of the Internal Revenue Code. The court stated that they did not need to consider the statutory phrase “all sources reportable to this state” because the parties agreed with the FTB’s 1997 Form 568 booklet defining the phrase as income before taking into account any apportionment and allocation.

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110 California Revenue and Taxation Code § 17942.
111 Northwest, 159 Cal.App.4th at 853. The California Forms & Instructions 568 booklet is provided by the FTB and contains instructions to filing LLC taxes.
112 California Franchise Tax Board, Forms & Instructions 568 (1997).
113 Northwest, 159 Cal.App.4th at 853; California Revenue and Taxation Code §§ 17942, 24271; I.R.C. § 61(a)(defining “gross income” as “all income from whatever source derived ...”).
consideration any apportionment and allocation.\footnote{Northwest, 159 Cal.App.4th at 853.} Ironically, after embarking on a useless de novo examination of the tax-fee distinction and a lengthy discussion of Pike, the court ignored seemingly ambiguous and critical language in section 17942 and instead relied solely on the FTB’s interpretation of the statute.

In National Muffler Dealers Association, Inc. v. United States, the United States Supreme Court stated that “the maxim noscitur a sociis, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth of the Acts of Congress.”\footnote{Nat’l Muffler Dealers Ass’n, Inc., v. U.S., 440 U.S. 472, 486 (1979)(citing Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961)).} Because Supreme Court decisions are binding precedent, Northwest was obliged to apply this maxim to aid in determining the meaning of “reportable to this state for the taxable year.” Admittedly, the FTB did define “total income from all sources reportable to this state” as meaning income before apportionment.\footnote{California Franchise Tax Board Form 568 (1997).} However, had the court applied the noscitur a sociis maxim, it may have been hesitant in accepting the FTB’s definition. This is because “reportable to this state for the taxable year” is associated with the word “total income.” And since “total income” is statutorily defined as income without apportionment\footnote{California Revenue and Taxation Code § 24271; I.R.C. § 61(a)} it would seem unnecessary to include the words “reportable to this state for the taxable year” to refer to unapportioned income also.
Additionally, the Supreme Court explained that “in determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose.”\(^{118}\) Had the Northwest court taken this approach, it likely would have considered whether the section 17942 levy as applied by the FTB was in accordance with the plain language of the statute. The FTB’s interpretation of 17942 arguably does not harmonize with the language of the statute. “Reportable to this state for the taxable year” in reference to “total income” suggests that the amount is in some way connected to the state. However, the FTB’s interpretation of this language as meaning unapportioned income requires no connection or attribution to the state.

A thorough analysis by the Northwest court would further have included examination of the legislative history of section 17942 to determine, beyond what the FTB asserts, what exactly was meant by its ambiguous language. Senate Bill 469 proposed the LLC Act including section 17942. However, an examination of the Bill reveals no mention of the words “reportable to this state for the taxable year.”\(^{119}\) Additionally, the California State Assembly recognizes that “current law lacks definition for ‘from all sources reportable to the state.’”\(^{120}\) Thus, there is little guidance as to the interpretation of the language as used in

\(^{118}\) *Nat’l Muffler*, 440 U.S. at 477.
\(^{120}\) A. 1546 (Ca. Feb. 23, 2007).
section 17942, aside from the FTB’s understanding. However, looking to the use of the language in other states’ statutes may have provided the court with valuable insight.

The Arizona Transaction Privilege Tax Procedure uses similar language in instructing how to calculate specific taxes. These procedures provide instruction on how to calculate taxes “reportable to the state/county and to the city.” Formulas are provided for allocating specific amounts to the state/county and to the city. Thus, the use of “reportable to …” here seems to imply apportionment. Likewise, 17 NCAC 06C .0110(b) of the North Carolina Administrative Code, dealing with tax associated with common carriers, states that “the amount of income reportable to this State shall be based on the percentage that the North Carolina flight time is to the total flight time for the year.” This North Carolina statute implies that income reportable to North Carolina is an apportioned amount dependant on the percentage of flight time in the state. On the other hand, however, several Oregon statutes use the language “reportable to [the state]” in association with income before apportionment.

California law lacked a definition for “sources reportable to [the] state,” as used in section 17942, and it appears that

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121 Arizona Transaction Privilege Tax Procedure TPP-001, http://www.revenue.state.az.us/ResearchStats/proc/tpp00-1.htm
122 Id.
123 North Carolina Administrative Code 17 NCAC 06C .0110(b).
124 See Multnomah County Business Income Tax Code § 12.110 (defining “income” as “arising from any business, as reportable to the state of Oregon for personal income … before any allocation or apportionment for operation out of state …”); see also Lane County Public Safety Income Tax Code § 4.501 (defining “business income” as “net income from any business, as reportable to the state of Oregon … before any allocation or apportionment for operation out of the state of Oregon …”).
the FTB was uncertain of its interpretation also. The FTB’s 1997 for 568 booklet stated that “total income from all sources reportable to California” meant income before taking into consideration apportionment and allocation. However, the 2006 booklet only defined “total income” as gross income before taking into consideration apportionment and allocation. An interpretation of the ambiguous language “reportable to …” is thus omitted in later versions of the FTB’s booklet. The latest issue of the 568 booklet released by the FTB is for the 2007 year and only provides information on the recently amended section 17942 levy. Consequently, this means that there was no statutory definition or published interpretation by the FTB for the ambiguous language in the former section 17942 at the time Northwest was heard by the California Court of Appeal.

Still, it is interesting that the court did not bother to look to the legislative history behind the language used in section 17942. After a lengthy discussion on the purpose of the statute for the tax-fee distinction, the court ironically found it unnecessary to look to the legislative history to determine whether or not section 17942 was meant to provide for apportionment.

2. An Alternative Decision

125 California Franchise Tax Board, Forms & Instructions 568 (1997).
127 California Franchise Tax Board, Forms & Instructions 568 (2007).
Current California Revenue and Taxation Code § 17942 replaced “reportable to this state” with “derived from or attributable to this state.”
The court could have found that section 17942 did intend for apportionment by the language used in the statute. Although this would entail rejecting the FTB’s seemingly uncertain interpretation, it would not have been an unreasonable decision. The Northwest court stated that such an interpretation would appear inconsistent with the statute’s legislative history.\(^{128}\) However the only information provided by the legislative history is that its purpose was to raise revenue. This does not lead to the conclusion that the levy imposed by the statute did not intend apportionment. Revenue is raised by the collection of money, with or without apportionment.

Interpreting section 17942 as providing for apportionment is perfectly in harmony with the language of the LLC Act. Although “total income” is statutorily defined as “gross income” under section 61 of the Internal Revenue Code, “reportable to the state” may reasonably have been understood to apply apportionment to the “total income” amount.\(^{129}\) Thus, by a close examination of the statute on its face, the court could have found that section 17942 provided for apportionment, and therefore met the Complete Auto test of constitutionality.

IV. Ventas Finance I, LLC v. California Franchise Tax Board

\(^{128}\)Northwest, 159 Cal.App.4th at 853.

\(^{129}\)California Revenue and Taxation Code § 17942.
The *Northwest* court noted that “as a general matter, only the portion of the Levy that exceeds Commerce Clause limits must be refunded.” In other words, the court basically wanted a retroactive apportionment of the amount paid under the levy in proportion to the amount earned within the state. In *Northwest*, this entitled NES to a full refund of its fees as none of its income was earned in California. In the related case of *Ventas Finance I, LLC v. California Franchise Tax Board*, the California Court of Appeal for the First District likewise held that the LLC was only entitled to a refund of “payments exceeding fairly apportioned assessments for years in issue.”

*Ventas* involves an LLC (“*Ventas*”) formed under the laws of Delaware. *Ventas* owns 39 to 40 skilled nursing facilities, three of which were located in California. *Ventas* registered as a foreign LLC in California from 2001 to 2003. It was therefore charged the LLC fee imposed under section 17942. Similar to NES, *Ventas* brought suit challenging the constitutionality of the levy. Although there it no indication of FTB’s plans to appeal the *Ventas* decision, as of yet it has not released a notice informing LLCs that they may claim refunds under the facts of *Ventas*.

California courts thus appear to be correcting the levy as interpreted and taxed by the FTB, while still declaring it

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<sup>130</sup> See *Northwest*, 159 Cal.App.4th at 868.
<sup>132</sup> *Id.* at 1213.
<sup>133</sup> *Id.*
unconstitutional. While some say that the section 17942 levy cannot be easily fixed,\textsuperscript{134} there might certainly have been an easier solution in retrospect. The FTB should not have agreed to total income from sources “reportable to this state” as restricting apportionment.\textsuperscript{135} The FTB, instead, should have focused its efforts on adjusting its interpretation of section 17942 to be more in line with the explicit language of the provision. Such a decision by the FTB would arguably have prevented much litigation on this matter.

\textit{Nathanael Cho}

\textsuperscript{134}\textit{California LLC Fees: New Taxpayer Victory Triggers State Action, J. Tax’N} (Apr. 2008) (“the state cannot pretend that the LLC ‘fee’ was apportioned when, in fact, it was not”).

\textsuperscript{135}\textit{Northwest, 159 Cal.App.4th at 853} (noting parties’ agreement on the interpretation of “total income”).