



DC Court Strikes Down Unincorporated Business Franchise Tax on Nonresident Individuals in *Bender v. District of Columbia*

James M. Grosser

In a significant taxpayer victory, the Superior Court of the District of Columbia ruled that applying the Unincorporated Business Franchise Tax to income distributable to individuals residing outside the District violates the so-called “commuter tax ban” in the District of Columbia Home Rule Act.

Impact on Taxpayers

- The *Bender* decision benefits any nonresident individual who owns an interest in an unincorporated business operating in the District of Columbia, regardless of the type of activity conducted by the unincorporated business. Resident individuals and corporations who own interests in unincorporated businesses operating in the District continue to be subject to the unincorporated business franchise tax (the “UB Tax”).
- In cases of unincorporated businesses structured with multiple tiers of partnerships and limited liability companies (“LLCs”), the *Bender* exemption should be applied by looking through all of the tiers to identify the distributable shares of all nonresident individual owners.
- While the exemption established in *Bender* is applied at the owner level, the payment obligation falls at the entity level. Therefore, partnerships and LLCs with taxable and tax-exempt owners will need to address the allocation of the UB Tax burden in their operative documents, taking into account such factors as the availability of credits for the tax in other states.
- The decision does not address the impact of the commuter tax ban on the taxation of S corporations owning interests in unincorporated businesses operating in the District. While the court’s

“economic burden” rationale could be applied to S corporations and their shareholders, this seems unlikely to occur given that District tax law draws no distinction between S corporations and C corporations. Consequently, individuals operating unincorporated businesses in the District through multi-tier structures will be disadvantaged if their structures include S corporations.

- The District of Columbia has not acquiesced in the result in *Bender*, and has stated that it plans to appeal. Until the appeals process is complete, taxpayers who follow *Bender* may face assessment for underpayment of tax, along with penalties and interest. Therefore, taxpayers should consider whether it is preferable to continue complying with the tax until the appeals process is exhausted. Protective refund claims can be submitted to preserve taxpayer rights.

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Background

The District of Columbia, unlike many state and local jurisdictions, imposes an entity-level income tax on partnerships, LLCs, and other non-corporate entities doing business in the District, even if such entities receive pass-through treatment for federal income tax purposes. This tax, often referred to as the UB Tax,¹ is a 9.975% annual tax on net income. Except for a few types of businesses specified in the statute, the UB Tax applies to any trade or business conducted in the District by a partnership, LLC, other non-corporate entity or individual.² For example, an LLC developing a residential condominium project in the District would be an unincorporated business under the statute. The UB Tax often comes as an unwelcome surprise to real estate investors and developers and others who are used to receiving pass-through treatment at the federal, state and local levels for their business ventures conducted through partnerships and LLCs.

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¹ DC Code § 47-1808.01, *et seq.*

² Examples of businesses carved out from the definition of “unincorporated business” include certain personal service businesses and businesses that by law, customs or ethics cannot be incorporated.

The Decision

In *Bender*, the Superior Court addressed an issue arising at the intersection of the UB Tax and the provision in the District's Home Rule Act³ commonly known as the "commuter tax ban." The commuter tax ban is a provision in the Home Rule Act barring the taxation of "personal income" of nonresident individuals. (Note that the commuter tax ban does not apply to the taxation of corporations, including S corporations.) The District of Columbia Court of Appeals previously determined in *Bishop*⁴ that, while the filing and payment obligations for the UB Tax fall on the unincorporated business, the economic burden of the UB Tax falls on the owners of the unincorporated business. Consequently, the court concluded that the application of the UB Tax to a professional services partnership constituted an impermissible tax on the personal income of the owners

of the unincorporated business, who were individuals residing outside the District.⁵

The principal issue in *Bender* was whether the holding in *Bishop* should be extended to encompass income from business activities other than professional services. In answering this question in the affirmative, the court reached the sweeping conclusion that all of the net income of a unincorporated business that is distributable to an individual is personal income:

"the Court holds that the [commuter tax ban] does effectively limit the Council's exercise of its [unincorporated business] regulatory authority to impose upon any [unincorporated business] net income to the extent that the [unincorporated business] distributes directly to nonresident individuals, whether professionals or otherwise."

The breadth of this conclusion is extremely favorable to taxpayers, with the minor caveat that the reference to income that the unincorporated business "distributes" is ambiguous and could be read to refer either to actual distributions or to distributable shares. In our view, however, the better reading is that "distributes" should be read to refer to distributable shares rather than actual distributions.

³ DC Code § 1-201.01, *et seq.*

⁴ 401 A.2d 955 (1979).

⁵ *Bishop*, which involved a law partnership, was decided during a period in which the statutory definition of "unincorporated business" did not include the present carve out for personal services businesses. Under current law, the law partnership in *Bishop* would not be an unincorporated business.

San Francisco Court Rules California LLC Tax Unconstitutional

Craig A. Becker

A San Francisco trial court has issued a tentative ruling concluding that California's Revenue and Taxation Code ("R&TC") section 17942 levy on limited liability companies ("LLCs") is an unconstitutional tax. *Northwest Energetic Services, LLC v. California Franchise Tax Board* (San Francisco Sup.Ct.No. CGC-05-437721, March 3, 2006).

The case concerned a Washington state LLC that never had any sales, property, payroll or other activity in California, other than registering with the California

Secretary of State. The taxpayer had paid the annual \$800 minimum tax under R&TC section 17941, but refused to pay the R&TC section 17942 levy based on gross LLC income from all sources, both within and without California. When assessed \$27,453 for six years of back tax, interest and penalties, the taxpayer paid the assessment and sought a refund. After being denied relief by the State Board of Equalization (which concluded it had no authority to address constitutional issues, SBE No. 236696, October 19, 2004), the taxpayer sued for refund in superior court.

The court first concluded that this "levy" is a tax, not a fee. The court found that the levy bore no relationship to either the California benefit provided the taxpayer or the burden imposed on California. Indeed the California legislature specifically provided separate LLC filing fees to cover administrative costs. The court noted the levy was

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well beyond any potential regulatory cost as the annual proceeds generated by R&TC section 17942 exceed the entire budget of the California Secretary of State. Finally, the R&TC section 17942 legislative history confirms that this “levy” was intended to replace tax revenues lost by business usage of new LLC flow-through entities rather than C corporations.

The court then concluded this LLC tax violates the commerce clause and due process clause of the United States Constitution because it is based on worldwide gross receipts and not apportioned between income sourced within and without California. The court noted this failure to calibrate the tax to the taxpayer’s California activity violates the four part test of *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977) (taxed activity must have nexus to the state, be fairly apportioned, not discriminate against interstate commerce and be fairly related to state provided services). The tax also fails to satisfy the required internal and external consistency tests as duplicate taxation would occur if other states applied the same taxing regime. See *Oklahoma Tax Comm’n v. Jefferson Lines, Inc.*, 514 U.S. 175, 189 (1995).

The California Franchise Tax Board (“FTB”) has asked the trial court to reconsider its decision, filing a March 20, 2006 brief claiming (among other things) that R&TC section 17942 is truly a fee (rather than a tax) because it is only imposed on those LLCs that choose to do business in California (a novel view that suggests that all California taxes are merely fees because they are paid by

businesses choosing to operate or individuals choosing to reside in California). Accordingly, the FTB will no doubt continue to enforce and collect the R&TC section 17942 tax as long as any avenue of appeal remains. Even if the FTB were not contesting the decision, it would not be binding precedent as it is only a trial court decision. The taxpayer in *Northwest Energetic* had no California source income or any other California presence. While the decision appears to conclude that R&TC section 17942 is an unconstitutional tax on all LLCs, including those with California activities, it remains uncertain whether a California court would be as willing to conclude the tax was unconstitutional for an LLC that generated all (or most) of its income from California sources.

Practitioners have long thought that R&TC section 17942 was subject to constitutional challenge because of its failure to apportion the tax base between in-state and out-of-state activity. The FTB recently published guidance for taxpayers seeking to file protective refund claims (Cal.CCH ¶ 403-983, March 16, 2006). Taxpayers seeking to protect their right to recover past R&TC section 17942 taxes need to file refund claims within four years of paying the tax. *R&TC §§ 19301 et seq.* Taxpayers paying the R&TC section 17942 LLC tax should review their particular facts and circumstances and file protective refund claims for the entire amount of the taxes paid in accordance with the recent FTB guidance. We are available to assist in computing the potential recoveries and preparing necessary refund claims.

