No. 150, Orig.

IN THE

Supreme Court of the United States

STATE OF ARIZONA
Plaintiff,

v.

STATE OF CALIFORNIA,
Defendant.

On Motion for Leave to File a Bill of Complaint

BRIEF FOR *AMICUS CURIAE* NATIONAL TAXPAYERS UNION FOUNDATION IN SUPPORT OF PLAINTIFF

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QUESTIONS PRESENTED

(1) Do California's Extraterritorial Assessments violate (a) the Due Process Clause or (b) the Commerce Clause?

(2) Do California's Extraterritorial Seizures violate (a) the Due Process Clause or (b) the Fourth Amendment?

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BRIEF OF *AMICUS CURIAE* NATIONAL TAXPAYERS UNION FOUNDATION IN SUPPORT OF PLAINTIFF

Pursuant to Supreme Court Rule 37.2, National Taxpayers Union Foundation ("NTUF") respectfully submits this *amicus curiae* brief in support of Plaintiff State of Arizona ("Arizona").[1]

INTEREST OF AMICUS CURIAE

Founded in 1973, *Amicus curiae* NTUF is a non-partisan research and educational organization dedicated to showing Americans how taxes, government spending, and regulations affect them. NTUF advances principles of limited government, simple taxation, and transparency on both the state and federal levels.

NTUF has worked extensively to analyze and provide testimony about the central questions contemplated by this case, including the launch of a project called the "Interstate Commerce Initiative" to explore the policy implications of extraterritorial action by States. A decision by this Court restraining Defendant State of California's ("California") extraterritorial assessments and seizures—the questions sought to be presented by Arizona—will

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[1] In accordance with Supreme Court Rule 37.2(a), counsel for NTUF notified the counsel of record for all parties at least ten days prior to the due date of this brief and all parties consent to the filing of this brief. No counsel for a party authored this brief in whole or in part, and neither the parties, their counsel, nor anyone except NTUF or its counsel financially contributed to preparing this brief.

have widespread effects on taxpayers, tax administration, and legislative and judicial disputes at the state and federal levels. For these reasons, NTUF has an institutional interest in the Court granting Arizona's motion for leave to file a bill of complaint.

SUMMARY OF ARGUMENT

Arizona's challenge to California's extra-territorial seizure of Arizona residents' Arizona-based property presents a proper vehicle for exercise of this Court's original jurisdiction because the dispute—which equates to a cross-border raid—is of such seriousness that it would amount to *casus belli* were the States fully sovereign. Because there is no alternative forum available to resolve the dispute, this Court should grant Arizona's motion for leave to file a bill of complaint.

California imposes "doing business" tax on out-of-state LLCs that are mere passive investors in an LLC that does business in California ("California LLC"), even if the California LLC has elected to be "manager-managed" so that the members play no role in management. Because passive investment does not satisfy the Fourteenth Amendment requirement that there be some definite minimum connection between a state and the person or property it seeks to tax, California's extra-territorial and extra-judicial seizures of bank accounts of non-resident LLCs that do no business in California are simple confiscations and deny due process of law.

California's confiscations are arbitrary and lack basic due process protections, such as notice and an opportunity to be heard. Because California issues seizure notices to taxpayers' multi-state banks, threatening to seize the banks' funds if they do not comply, it has been successful in coercing remittance of funds from Arizonans' bank accounts without customer consent. Out-of-state taxpayers, accordingly, lack recourse unless they submit to the jurisdiction of California courts as plaintiffs. Not only does such process require taxpayers to forego one right in an attempt to vindicate another, it is impractical in light of the small-dollar value of each individual claim, which could easily be devoured by the cost of seeking redress. Moreover, the basis on which California applies "doing business" tax is simultaneously vague—lacking explanation, and dubiously precise—turning on an ownership interest of 0.2 percent as the threshold for imposing the tax.

This taxation without representation—imposing the will of the California legislature on Arizona residents—parallels grievances that drove the Colonies to separate from Great Britain and violates the Constitution's recognition that states are sovereign within their own borders but that their power stops at their border's edge.

Finally, California's extraterritorial seizures violate the Commerce Clause because they are grievously malapportioned, lack a substantial nexus, and discriminate against interstate commerce. The imposition of double taxation on out-of-state passive investors impedes the liquidity of their investments in California LLCs and saddles them with additional

record-keeping and investigatory burdens that in-state investors do not bear.

Arizona taxpayers have no meaningful recourse against these constitutional violations except through their State before this Court. If another venue were available, clear precedent would compel relief for Arizona and its residents. But no other venue can be had in a dispute between states. Accordingly, the Court should grant Arizona's motion.

ARGUMENT

I. This Case is a Proper Vehicle for This Court's Exclusive Jurisdiction.

Original jurisdiction should be used only sparingly. *Wyoming v. Oklahoma*, 502 U.S. 437, 450 (1992). In determining whether to accept a case for review, the Court looks to two factors. First, the Court examines the "interest of the complaining State, focusing on the seriousness and dignity of the claim." *Mississippi v. Louisiana*, 506 U.S. 73, 77 (1992) (cleaned up). "'The model case for invocation of this Court's original jurisdiction is a dispute between States of such seriousness that it would amount to *casus belli* if the States were fully sovereign.'" *Id.* (quoting *Texas v. New Mexico*, 462 U.S. 554, 571 (1983)). Second, the Court examines whether an alternative forum is available to resolve the dispute. *Id.* "Original jurisdiction is for the resolution of *state* claims, not private claims." *South Carolina v. North Carolina*, 558 U.S. 256, 277 (2010) (Roberts, C.J., concurring in part and dissenting in part) (citations omitted).

Arizona's sovereign interests are set forth in its motion and need not be repeated here. Instead, this brief focuses on California's dogged violations of the constitutional rights of Arizona taxpayers, which can only be adequately addressed by resolving Arizona's claims in this Court. Arizona has estimated that those violations have an annual impact of over $10 million on Arizona taxpayers alone. Compl. ¶ 65. The nationwide effect is undoubtedly magnitudes greater.

California's cross-border seizure of funds from the bank accounts of Arizona residents amounts to *casus belli* in the classic sense of requiring collective self-defense. But unlike conventional cross-border raids that rely on physical mobilization, technological advances allow California to reach into Arizona bank accounts without physically traveling outside its own borders. This precedent, if allowed to stand, would allow any state with revenue aspirations to reach passive investors in every other state by using multi-state banks as conduits for backdoor extractions. Accordingly, this Court should accept jurisdiction over this matter to allow Arizona to vindicate its rights to protect its borders and the in-state property of its residents.

II. California Does Not Afford Due Process for Out-of-State Taxpayers.

This case presents important due process issues for non-California LLCs that are passive investors in California LLCs. These investors lack any meaningful recourse against California's extra-territorial seizures of their out-of-state bank accounts.

"It is a venerable if trite observation that seizure of property by the State under pretext of taxation when there is no jurisdiction or power to tax is simple confiscation and a denial of due process of law." *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 342 (1954). The power to tax is limited to situations where the state has jurisdiction over the person or the property. *Id.* (citing *City of St. Louis v. Wiggins Ferry Co.*, 78 U.S. 423, 430 (1870) ("Where there is jurisdiction neither as to person nor property, the imposition of a tax would be ultra vires and void.")).

Accordingly, the Due Process Clause of the Fourteenth Amendment requires that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Id.* at 344–45. Moreover, prior to depriving an owner of property, due process requires the government to provide the owner "'notice and opportunity for hearing appropriate to the nature of the case.'" *Jones v. Flowers*, 547 U.S. 220, 223 (2006) (citing *Mullane v. Cent. Hanover Bank & Tr. Co.*, 339 U.S. 306, 313 (1950)). California's scheme to confiscate "doing business" taxes from out-of-state bank accounts fails to satisfy due process on all points.

A. Out-of-State Passive Investors Lack the Requisite Minimum Contacts.

Under California law, "doing business" tax may be imposed on an LLC that is "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit" in California and satisfies any of the following characteristics: (1) it is organized or

commercially domiciled in California; (2) it has sales in California of the lesser of five hundred thousand dollars or twenty-five percent of the taxpayer's total sales; (3) it owns real property and tangible personal property in California exceeding the lesser of fifty thousand dollars ($50,000) or twenty-five percent of the taxpayer's total real property and tangible personal property; or (4) it pays compensation in California of the lesser of fifty thousand dollars ($50,000) or twenty-five percent of the total compensation paid by the taxpayer. Cal. Rev. & Tax. Code §§ 17941, 23101. These criteria are unambiguous, material, and sufficiently precise to notify a potential taxpayer that the State would exert jurisdiction and impose taxes.

But the California Franchise Tax Board ("Tax Board") goes further, imposing duplicate "doing business" taxes on out-of-state LLCs that are mere passive investors in manager-managed California LLCs, when the investor is domiciled in another state, has no sales in California, has no real or tangible personal property in California, and does no business in California.

This Court already has addressed the issue of whether a state may exercise personal jurisdiction over an out-of-state shareholder of an in-state corporation and held that it could not. *Shaffer v. Heitner*, 433 U.S. 186, 213 (1977); *accord Pac. Life Ins. Co. v. Spurgeon*, 319 F. Supp. 2d 1108, 1114 (C.D. Cal. 2004) (holding that a passive investor in an annuity contract, despite an ongoing relationship with the California entity, lacked sufficient contacts to assert personal jurisdiction). Accordingly, California's

assertion of jurisdiction over out-of-state LLCs that are passive investors is at odds with both the plain language of the Due Process Clause and subsequent jurisprudence applying it.

B. California's Criteria for Targeting Taxpayers is Arbitrary.

Imposition of "doing business" tax on an out-of-state passive investor also violates the plain meaning of the California Code ("Code") because it imposes seizure of property on the out-of-state taxpayer despite having no reasonable expectation that it has "subjected itself to the taxing power" of California. *Miller Bros. Co.*, 347 U.S. at 344.

Early attempts by the Tax Board to bypass the limitations of the Code and impose "doing business" tax on any out-of-state LLC with any degree of ownership interest in a manager-managed California LLC were foreclosed by the California Court of Appeal in *Swart Enterprises, Inc. v. Franchise Tax Board*, 7 Cal. App. 5th 497 (Cal. Ct. App. 2017) [hereinafter *Swart*]. In *Swart*, the court held that the plaintiff, an Iowa corporation that held a meager 0.2 percent membership interest in a manager-managed California LLC, was not "doing business" in California, and therefore was not subject to the franchise tax.

The Tax Board declined to appeal the *Swart* decision. Instead, it responded by "following" *Swart*, but only in "situations with the same facts." Calif. Franchise Tax Board, Legal Div. MS A260, FTB Notice 2017-01 (Feb. 28, 2017), *available at*

http://bit.ly/2VwhoRS. Accordingly, the Tax Board grants or denies claims for refund of annual “doing business” tax based on the following criteria, which appear verbatim on the Franchise Tax Board Claim for Refund Denial:

- The only connection with California was 0.2 percent membership interest in an LLC that was doing business in California.
- The California LLC was manager-managed.
- The original members of the California LLC made the decision to delegate their authority to a manager before Swart Enterprises, Inc. acquired its membership interest in the California LLC.

Compl., Ex. D.

Failure to satisfy any of these criteria results in a denial of refund with no explanation other than the entry of an “X” next to the selection that reads: “You did not meet one or more of the above facts as per the *Swart* decision.” *Id.* The specific facts that the taxpayer failed to meet are not identified. This check-the-box response provides no explanation of how the analysis was performed or why these seemingly nonsensical criteria matter.

The second criterion is the only one that has any logic or predictive ability, reflecting a discrete decision by the owner(s) regarding whether the ownership

interest(s) would be passive or active. The first and third criteria are merely artifacts of the factual situation in *Swart*, have no bearing on whether the out-of-state owner manages the in-state LLC, and do not reflect any connection between the passive owner and the State. They are happenstance characteristics used to assert jurisdiction over out-of-state owners with no ties to California other than passive investment.

The first criterion, the 0.2 percent ownership limit, lacks any rationale or legal basis. There arguably may be a meaningful difference between a 0.2 percent ownership interest and a 50 percent ownership interest—or even the 25 percent threshold on sales, property, or compensation repeatedly referenced in the Code. *See* Cal. Rev. & Tax. Code § 23101. But any difference at the *de minimis* end of the spectrum—say, between a 0.1 percent interest and a 1 percent interest—is inherently arbitrary, and not designed to put the out-of-state investor on notice that the State would deem it to be "doing business" in California.

The third criterion is even more troubling because it is not only arbitrary, but also ambiguous and incurable. The facts in *Swart* show that the California LLC was formed in 2005. It was designated as manager-managed in its articles of organization and operating agreement, which gave the sole manager "'full, exclusive and complete authority in the management and control of the business of the Fund[.]'" *Swart*, 7 Cal. App. 5th at 501 (citation omitted). Swart, the out-of-state investor, became a member of the LLC in 2007, by making an investment that amounted to a 0.2 percent ownership interest. *Id.*

Contrast these facts to the language of the Tax Board's Claim for Refund Denial, which reads:

- The original members of the California LLC made the decision to delegate their authority to a manager before Swart Enterprises, Inc. acquired its membership interest in the California LLC.

Compl., Ex. D.

For a taxpayer to "not meet" this criterion, could have a variety of meanings, including, but not limited to, that the original members of a California LLC made the decision for the LLC to be manager-managed prior to:

1) 2007;

2) the investment into the LLC of any non-original member;

3) the investment into the LLC of any member after the election to be manager-managed was made (even if other non-original members invested in the meantime); or

4) the investment into the LLC of only the out-of-state investor that California seeks to tax.

The variety of reasonable interpretations of the third criterion eliminate the ability for an out-of-state investor reasonably to anticipate whether *Swart* would apply. It also precludes any ability to

understand the basis for the Tax Board's determination. Reliance on consistent and fair application of the criteria is impossible because the Tax Board provides no explanation for its determination that the taxpayer did not meet the "facts."

Finally, it appears that the outcome from the third criterion is locked-in for all time, regardless of any changes in ownership. For example, if the original members of a California LLC do not elect for the LLC to be manager-managed prior to transferring any ownership interest, then any subsequent investors would be deemed to be "doing business" in California even if they each had a vanishingly small ownership percentage and even if the owners amended the articles of incorporation and operating agreement to convert the LLC to manager-managed. Such an outcome would not reflect the reality of an out-of-state investor with a *de minimis* ownership interest. These tactics make clear that the Tax Board is not faithfully applying the Code and legal precedent but is stubbornly pursuing revenue from out-of-state investors that cannot meaningfully resist unlawful seizure.

C. California's *Ex Parte* Seizures of Out-of-State Funds Lack Procedural Protections.

Before the government may deprive an owner of property, it must provide an "'opportunity for hearing appropriate to the nature of the case.'" *Jones*, 547 U.S. at 223 (citing *Mullane*, 339 U.S. at 313). California's

ex parte seizures of out-of-state property lack those requisite procedural protections.

Because California lacks personal jurisdiction over the out-of-state target, it cannot use its state courts to enforce its assessments by seeking a court order and then relying on the Full Faith and Credit Clause to enforce the order in another state. Instead, California locates money held by multi-state banks in out-of-state bank accounts and sends a seizure order to the bank demanding that the bank remit the non-California LLC's funds to California. California law allows the Tax Board to issue these seizure notices at its discretion. Cal. Rev. & Tax Code § 18670.

If the bank refuses, California threatens to extract the same amount from the bank instead. *Id.* § 18670(d). The seizure orders are issued *ex parte*—without warrant or judicial involvement—and purport to preclude banks from seeking judicial review. *Id.* §§ 18670.5(a), 18674(a). Banks are thus deprived of their due process rights as well. Either they sacrifice their own funds without recourse or they acquiesce in being pressed into service as California's collection agent by executing unlawful seizure notices and depriving their own customers of property. Whenever California successfully coerces a bank into remitting its customer's funds, that customer is deprived of property without an opportunity to be heard.

D. Out-of-State Taxpayers Have No Meaningful Recourse Against Unlawful Seizures.

The only recourse available to out-of-state taxpayers whose funds have been seized is filing suit in California and subjecting themselves to the jurisdiction of the California courts, thus surrendering the very due process rights—lack of personal jurisdiction—they would be in court to defend. Out-of-state taxpayers face a Hobson's choice: sacrifice their individual liberty or forego challenging the seizure of their property. Either way, their due process right to be subject only to lawful power is compromised. *J. McIntyre Mach., Ltd. v. Nicastro*, 564 U.S. 873, 884 (2011) (quoting *Ins. Corp. of Ireland v. Compagnie des Bauxites de Guinee*, 456 U.S. 694, 702 (1982) ("Personal jurisdiction, of course, restricts 'judicial power not as a matter of sovereignty, but as a matter of individual liberty,' for due process protects the individual's right to be subject only to lawful power.")).

Moreover, from a practical standpoint, the low dollar amount of the tax ($800), Cal. Rev. & Tax. Code §§ 17941(a), 23153(d)(1), provides a barrier to seeking judicial recourse because the cost of travelling to court in California would exceed the relief sought even before considering court costs, attorneys' fees, and opportunity costs. California has thus created a scenario in which out-of-state taxpayers cannot vindicate one right without sacrificing another at a potential cost that would leave the taxpayer worse off than merely acquiescing to the seizure.

E. California is Imposing Taxation Without Representation.

It remains a fundamental tenet of the rights of Americans, and of Englishmen before them, that taxation shall not be imposed without representation.

> The very act of taxing, exercised over those who are not represented, appears to me to be depriving them of one of their most essential rights, as freemen; and if continued, seems to be in effect an entire disfranchisement of every civil right. For what one civil right is worth a rush, after a man's property is subject to be taken from him at pleasure, without his consent?

James Otis, *Rights of British Colonies Asserted and Proved* (1764), in *The American Republic: Primary Sources* at 122 (Bruce Frohnen ed., 2002), *available at* http://bit.ly/2UJYK9B. The Framers took care to provide that the concurrent authority between the federal government and the states—as well as among the states—leaves each accountable to its own citizens. "The great innovation of this design was that our citizens would have two political capacities, one state and one federal, each protected from incursion by the other . . . each with its own direct relationship, its own privity, its own set of mutual rights and obligations to the people who sustain it and are governed by it." *Printz v. United States*, 521 U.S. 898, 920 (1997) (citations omitted).

Among the States, this structure ensures that each state represents and remains accountable to its own citizens but has no interest in protecting the non-resident. *Id*. (citations omitted). State sovereignty, in turn, implies "a limitation on the sovereignty of all of its sister States—a limitation express or implicit in both the original scheme of the Constitution and the Fourteenth Amendment." *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 293 (1980); *see Bond v. United States*, 564 U.S. 211, 221 (2011) ("The allocation of powers in our federal system preserves the integrity, dignity, and residual sovereignty of the States."). Thus, a state may tax those it represents, but it may not exert its authority in conflict with the sovereignty of another state.

But that is exactly what California is doing. Non-residents are unrepresented in the California legislature. Yet, the California Code expressly allows the direct taxation of non-residents across state lines via demand on the investor's financial institution, Cal. Rev. & Tax Code § 18670, thus usurping the investor's right to be taxed only by legislatures in which it is represented. Accordingly, California's usurpation of the rights of residents of other states to be free from taxation without representation, and its incursion into its sister States' rightful authority to tax within their own jurisdictions, is an infringement worthy of review by this Court.

F. California's Orders to Withhold Tax Effectuate a Modern-Day Raid Across State Lines.

California's seizure orders relate to electronic funds and do not require physical entry into Arizona or absconding with sacks of cash. But the virtual character of the transaction does not change its nature: California is crossing state lines to seize bank funds of non-residents.

It is well-established that bank deposits "have situs at the domicile of the creditor[.]" *Baldwin v. Missouri*, 281 U.S. 586, 591 (1930). Seizing those funds is analogous to trying to tax or escheat them—issues that this Court has deemed worthy of review. *See, e.g.*, *Texas v. New Jersey,* 379 U.S. 674, 682 (1965), *supplemented by* 380 U.S. 518 (1965) (holding that the address of the creditor determines the state in which the property is subject to escheat); *Virginia v. Imperial Coal Sales Co.*, 293 U.S. 15, 19 (1934) ("[C]redits and accounts are regarded as situated at the domicile of the creditor, and that domicile establishes a basis for taxation."); *see also In re State Tax on Foreign-Held Bonds*, 82 U.S. 300, 301 (1872) (taxation of interest on bonds held by non-residents, "is not . . . a legitimate exercise of the taxing power of the State").

Moreover, cross-border raids of horses, cattle, and goods are classic examples of *casus belli*. *See generally* Jeffrey Marcus Becker, *Armed conflict and border society: The East and Middle Marches, 1536-60* (Oct. 2006) (Ph.D. dissertation, University of Durham), *available at* http://bit.ly/2ZIOEEB. Accordingly,

California's cross-border raids of Arizona bank accounts present the type of dispute that can and should be resolved by this Court, *see Mississippi*, 506 U.S. at 77 ("'The model case for invocation of this Court's original jurisdiction is a dispute between States of such seriousness that it would amount to *casus belli* if the States were fully sovereign.'") (citation omitted), and is consistent with other cases.

III. California's Imposition of Arbitrary and Discriminatory "Doing Business" Tax Violates the Commerce Clause.

The Commerce Clause places two limitations on the States. U.S. Const., art. I, § 8, cl. 3. First, states may not discriminate against interstate commerce; and second, states may not place an impermissible burden on interstate commerce. *Granholm v. Heald*, 544 U.S. 460, 476–77 (2005). A state law "that discriminate[s] against interstate commerce face[s] a virtually *per se* rule of invalidity." *Id.* at 476 (citation omitted).

A State may tax interstate commerce "so long as the tax does not create any effect forbidden by the Commerce Clause." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 285 (1977) [hereinafter *Complete Auto*]. To avoid offending the Commerce Clause, a state tax must (1) apply to an activity with a substantial nexus with the taxing State, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services the State provides. *Id.* at 279.

California's imposition of "doing business" tax on out-of-state LLCs discriminates against and imposes undue burdens on interstate commerce by failing to satisfy each of the governing characteristics required by *Complete Auto*.

A. Out-of-State Passive Investors Lack a Substantial Nexus with California.

California's assessment of "doing business" tax on out-of-state passive-investor LLCs fails the first prong of the *Complete Auto* test because it is imposed despite a complete lack of activity in California—non-existent activity cannot have substantial nexus to California.

Sufficient nexus under *Complete Auto* is "established when the taxpayer 'avails itself of the substantial privilege of carrying on business' in that jurisdiction." *Polar Tankers, Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009) (citations omitted). Out-of-state LLCs that are mere passive investors in other LLCs do not "carry on business" in California in any sense.

Under California law, an LLC has a legal existence separate from its members. *See Kwok v. Transnation Title Ins. Co.*, 170 Cal. App. 4th 1562, 1571 (Cal. Ct. App. 2009). An LLC may be (1) member managed or (2) manager managed. *People v. Pac. Landmark, LLC*, 129 Cal. App. 4th 1203, 1212 (Cal. Ct. App. 2005). If it is member managed, then the members actively participate in the management and control of the company. *Id.* But in a manager-managed LLC, "[w]hile LLC members have the ability to remove the manager with a majority vote, they have no right to

control the management and conduct of the LLC's activities, nor do they have the apparent authority to do so." *Swart*, 7 Cal. App. 5th at 510. Being a member of a manager-managed LLC is about as far from control as it is possible to get without avoiding ownership altogether. And—given the paltry ownership threshold of 0.2 percent that the Tax Board deems sufficient to trigger the tax—the extent to which the out-of-state investor could exercise control over the in-state business is doubtful.

B. California's "Doing Business" Tax is Not Fairly Apportioned and If Applied by All States Would Dramatically Increase the Burden on Interstate Commerce.

California's imposition of "doing business" tax on out-of-state passive investors is grossly disproportionate. Whether a tax is malapportioned is assessed by looking at whether the tax is "internally consistent" and "externally consistent." *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995). The California "doing business" tax fails both.

The "internal consistency" test helps courts identify tax schemes that discriminate against interstate commerce by assuming that every state has the same tax structure. *Comptroller of Treasury of Md. v. Wynne*, 135 S. Ct. 1787, 1791 (2015). A tax scheme fails the internal consistency test if adoption of the scheme by every state would result in interstate commerce being taxed at a higher rate than intrastate commerce. *Id.*

California's "doing business" tax is a flat tax of $800. Cal. Rev. & Tax. Code §§ 17941(a), 23153(d)(1). It is not apportioned according to degree of ownership or activity. If every state in the Union were to apply a similar flat tax of $800 per out-of-state owner, then mere passive ownership of in-state LLCs by out-of-state LLCs could result in incremental taxation of up to $400,000 per in-state LLC—a massive burden across the country imposed solely on out-of-state investors.[2] Ownership of LLCs solely by same-state LLCs, on the other hand, would result in incremental taxation of $0 because those owners would already be paying "doing business" tax based on being organized or commercially domiciled within the state and would not be taxed again on their ownership of another LLC. California's imposition of "doing business" tax on out-of-state passive investors is not internally consistent.

External consistency, by contrast, 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." *Jefferson Lines, Inc.*, 514 U.S. at 185; *see Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983) ("[T]he factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."). In imposing "doing business" tax, California does not employ an apportionment formula that reflects the value of activity within the state. Instead, the tax

[2] Assuming the minimum threshold ownership to trigger the tax of $800 per owner of 0.2 percent interest and all owners being out-of-state, the in-state LLC would have 500 out-of-state owners and be taxed: $800 x 500 = $400,000.

varies solely with the proportion of out-of-state ownership, with aggregate "doing business" tax maximized where each out-of-state owner holds an exactly 0.2 percent interest and dropping immediately to zero when every out-of-state owner holds less than a 0.2 percent interest.

For example, for a California LLC that is owned by 500 out-of-state investors with equal ownership interests, the total "doing business" tax imposed would be $400,000. But for an identical LLC with 501 out-of-state investors with equal ownership interests, the total "doing business" tax would be $0.00 because each investor would own less than a 0.2 percent interest and thus no "doing business" tax would be imposed. There is no rationale for this abrupt variation based on the addition of a single additional out-of-state investor. Conversely, should the 501st investor wish to divest its share to the remaining 500 investors, that gift or sale would push the other investors over the "doing business" threshold and spontaneously create a material tax burden that would reflect no economic activity in California. The material effect of the tax would provide an incentive for out-of-state LLCs to artificially dilute their ownership interests even when a dispersed ownership structure makes no business sense.

Because there is no relationship between the tax and any economic activity within California, imposition of "doing business" tax on out-of-state passive investor LLCs is not externally consistent.

C. California's Doing Business Tax Discriminates Against Interstate Commerce.

In addition to burdening interstate commerce with higher taxes than intrastate commerce, California's imposition of "doing business" tax on out-of-state passive investors imposes non-tax burdens on interstate investors that do not affect intrastate investors.

1. Out-of-State Investors Face an Impediment to Liquidity.

In-state investor LLCs may own as much or as little of another in-state company as they want with no effect on their own "doing business" assessment. Out-of-state investors, on the other hand, must take into consideration the effect of any change in their proportional ownership of a California LLC. If their ownership share crosses the 0.2 percent threshold, then the "doing business" tax applies. This difference burdens liquidity for out-of-state investors in a myriad of ways, including the following:

- Out-of-state investor LLCs with less than a 0.2 percent ownership interest that want to increase their investment in a California LLC must either ensure that their ownership percentage does not exceed 0.2 percent to avoid increased tax burden or must account for the increased tax burden in determining how much to pay for any additional investment. In-state investor LLCs do not have that concern.

- Out-of-state investors would be at a disadvantage when negotiating with or against an in-state buyer or seller because the parties would know that only the out-of-state investor must consider the effect of the tax on its willingness to make a purchase or sale.

- For any California LLC where the original members did not elect to be manager-managed at the time of formation, any later election of that model would not remove the tax burden from out-of-state investor LLCs (per one possible reading of *Swart*). This deprives out-of-state investor LLCs of a meaningful benefit of ownership—control over the election of management model—by mooting the ability to benefit from selecting the manager-managed model.

2. Out-of-State Investors Bear Greater Record-keeping and Pre-investment Investigation Burdens.

To address the issues identified above, potential out-of-state investor LLCs bear additional record keeping and investigational burdens that do not affect in-state investor LLCs. For example, out-of-state investor LLCs are burdened with investigating whether potential investments comply with the "facts" in *Swart*—assuming the investor can figure out what those facts are before making an investment decision. In-state investor LLCs do not bear that burden.

Out-of-state investors may also need to consider the tax effect of buy-outs, *e.g.* in a divorce settlement, or testamentary gifts that may consolidate ownership

interests. In-state investor LLCs do not bear the burden of coordinating these concerns.

Out-of-state investor LLCs are also burdened with maintaining ownership percentage records, both to prepare to refute a potentially erroneous imposition of taxes by the State and in case the investor wants to increase or decrease its investment. In-state investor LLCs do not bear that burden.

3. Out-of-State Investors Must Consider Whether Their Choice of Bank May Expose Them to *Ex Parte* Seizure of Funds.

California's issuance of seizure orders to banks appears to be wholly opportunistic and limited to banks that do business in California and in the home state of the target LLC. The coercive value of threatening to hold the bank liable for the alleged tax would be greatly diminished for any bank that does not do business in California—and conversely would be heightened for any bank that could be exposed to a stream of seizure notices because it does a great deal of business in California.

Thus, an out-of-state investor LLC would be prudent to consider whether to maintain its bank account in a multi-state bank that does business in California or to keep it in a local bank that would not be easily strong-armed into relinquishing its customer's funds. Avoidance of multi-state banks that do business in California appears to be protection against unexpected seizure of funds and a guarantee that any attempted imposition of "doing business" tax

could be addressed before the funds are seized. But such a choice may impose other costs or inconveniences on the investor. The burden of weighing whether to select from a limited pool of local banks, or to expose oneself to confiscation of assets, is imposed only on the out-of-state investor LLC and would not affect a California investor. If such a system were imposed by all states, it would severely burden interstate commerce.

D. Passive Investors Receive No Services from the State.

The fourth prong of the *Complete Auto* test requires that a state tax be fairly related to the services the State provides. *Complete Auto*, 430 U.S. at 279. California's assessment of "doing business" tax on out-of-state passive investor LLCs fails this prong. As passive investors, the targets of the seizure notices receive no services from the State. Instead, the California LLC in which they invested receives the benefit of any services the State provides—and, accordingly, pays "doing business" tax in its own name. Any additional tax imposed using the California LLC as the conduit to reach out-of-state investors constitutes a second layer of taxation.

Moreover, for the same reasons that "doing business" tax is not fairly apportioned to activity in the State, it likewise does not reflect services from the State. The amount of "doing business" tax imposed reflects merely proportional ownership between in-state and out-of-state investors, and the number of investors—neither of which have any relation to

services provided by the State. Accordingly, the fourth prong of the *Complete Auto* test is not satisfied.

CONCLUSION

For the foregoing reasons, this Court should grant the State of Arizona's motion for leave to file a bill of complaint.

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