

# Client Alert.

December 15, 2010

## California Court of Appeal Upholds Twenty Percent Understatement Penalty

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### BACKGROUND

In 2008, the California Legislature enacted SBX1 28 which added section 19138 to the California Corporation Tax Law. As enacted in 2008, section 19138 imposed a new penalty, as specified, on taxpayers subject to the California Corporation Tax Law equal to twenty percent of the understatement of tax in excess of one million dollars for any taxable year. The penalty applies to taxable years beginning on or after January 1, 2003 for which the statute of limitations has not expired. With rare exceptions, this is a “strict liability penalty” with no discretion given to the California Franchise Tax Board (“FTB”) to forgo the penalty on such traditional grounds for relief as reasonable cause, substantial authority or adequate disclosure. As enacted in 2008, for taxpayers included in a combined report, the one million dollar threshold applies to the aggregate amount of tax liability for all taxpayers included in the combined report. For purposes of computing the twenty percent penalty, “understatement of tax” means the amount by which the tax imposed by the California Corporation Tax Law exceeds the amount of tax shown on an original return or an amended return filed on or before the original or extended due date of the return for any taxable year.<sup>1</sup>

On February 17, 2009, and soon after the penalty’s enactment, the California Taxpayers’ Association (“CalTax”) filed a petition for writ of mandate in Sacramento County Superior Court<sup>2</sup> challenging the constitutionality of section 19138. The petition raised a number of arguments, including: (1) section 19138 is a “tax” (not a “penalty”) which requires for passage under article 13A, section 3, of the California Constitution, at least a two-thirds vote of the Legislature, but which passed the Legislature by a majority vote; and (2) section 19138 violates procedural due process guarantees of the Fourteenth Amendment because it affords no pre-payment or post-payment review. The petition asked the trial court to issue a writ of mandate commanding the FTB to cease enforcing section 19138, for a declaration that section 19138 was unconstitutional, and for an injunction prohibiting the FTB from enforcing section 19138. CalTax asked that these actions take place before May 31, 2009 to avoid irreparable harm to taxpayers who otherwise would be required to file amended returns by that date in order to avoid the penalty. On May 20, 2009, the trial court denied the petition for mandate and for other relief. CalTax appealed.

### THE COURT OF APPEAL DECISION

On December 13, 2010, in a published decision, the California Court of Appeal, Third Appellate District, affirmed the trial court’s decision and unanimously upheld the constitutionality of section 19138.

After preliminarily rejecting in a footnote the FTB’s claim that CalTax lacked standing to bring the action, the court first

<sup>1</sup> However, for any taxable year beginning before January 1, 2008, the amount of tax paid on or before May 31, 2009, and shown on an amended return filed on or before May 31, 2009, is to be treated as the amount of tax shown on an original return. This provision resulted in a substantial number of filings of “protective” amended returns shortly before May 31, 2009 for taxable years beginning on or after January 1, 2003.

<sup>2</sup> Sacramento County Superior Court No. 34-2009-80000168.

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addressed the issue of whether section 19138 imposes a “tax” or a tax increase subject to the two-thirds legislative vote requirement. The court held the section 19138 penalty is not a “tax” or a tax increase subject to the two-thirds vote requirement. Initially, the court pointed out that there is no decisional law directly on point. It then went on to reject CalTax’s proposed analytical framework under a series of decisions beginning with *Beaumont*,<sup>3</sup> which the court characterized as standing for the proposition that a “tax” is the general rule and a “fee” the limited exception. The court declined to apply this tax rule/fee exception approach, reasoning the case at bar dealt with a statutory “penalty” that applies only if a “tax” has not been fully paid. Instead, the court employed what it termed the traditional analytical framework, “roughly the converse of the *Beaumont* framework,” for determining a statute’s constitutionality, i.e., a statute is presumed to be constitutional and the burden is on the challenger to show otherwise.

Applying this traditional framework, the court stated the question of whether an imposition is a “tax” is not simply a question of raising revenue; and in any event, the record showed projected *declining* revenue from the section 19138 penalty. According to the court, “[t]his is not evidence of a tax, because a tax has as its primary purpose the raising of revenue.” The court went on to explain its conclusion that section 19138 is a penalty, and not a tax, is supported by three other observations. First, a tax raises revenue if it is obeyed, while a penalty raises revenue only if some legal obligation is disobeyed. Here, the section 19138 penalty directly raises revenue only if a corporate taxpayer has disobeyed a legal obligation (by understating its actual tax liability by over one million dollars). Second, the court found section 19138 is not a tax because it did not impose an increase in the tax rate or change the method of tax computation, which it viewed as the benchmarks of a tax under article 13A, section 3 of the California Constitution. Third, even though section 19138 was enacted during an extraordinary session of the California Legislature dealing with the 2008-2009 state budget deficit, the court found the primary purpose of section 19138 was not to raise revenue to balance that budget. The court concluded the question of whether an imposition is a “tax” is not simply a question of raising revenue, but *how* that revenue is raised, and noted the projected revenues from section 19138, while significant in the first year of operations, declined steeply and continuously in subsequent years.

The court also highlighted that section 19138 has been described in its legislative history as a tax penalty. Finally, the court dismissed the rate of the penalty (twenty percent) as indicia of tax, concluding the rate is not excessive because it is in line with the federal tax penalty found in the Internal Revenue Code for substantial understatements.

Next, the court rejected CalTax’s argument that section 19138 violates taxpayers’ procedural due process rights because it affords no pre-payment or post-payment review process, except on the ground the FTB did not “properly compute” the penalty amount. Specifically, the court held that section 19138, as “properly construed,” affords due process to taxpayers. While section 19138 itself does not provide for a pre-payment or a post-payment review process (other than for FTB’s computational errors), the court concluded this limitation was intended to apply only to *administrative* refund claims. Independent of section 19138, California Revenue and Taxation Code section 19382 (“section 19382”) generally permits a taxpayer to bring a judicial refund action after payment of the tax and denial by the FTB of a claim for refund. The court rejected CalTax’s due process challenge to section 19138 by reasoning that section 19382 provides a constitutionally adequate post-deprivation remedy in the form of a judicial refund action in which taxpayers may contest the validity of the section 19138 penalty. However, absent the section 19382 remedy, the court recognized section 19138 would not pass the constitutional muster. According to the court, section 19138(e) alone “does not satisfy this due process mandate, because its procedural safeguard is limited only to penalty amounts ‘not properly computed’ by the Board.”

<sup>3</sup> *Beaumont Investors v. Beaumont-Cherry Valley Water District* (1985) 165 Cal.App.3d 227.

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Clearly, if allowed to stand, the December 13 opinion of the Court of Appeal is a major taxpayer loss, but the opinion is currently still procedurally subject to both a petition for rehearing and discretionary review by the California Supreme Court. Notably, the court focused its opinion around the two central issues of section 19138 – whether a “tax” was disguised as a “fee” and the due process concerns surrounding the lack of a specific pre-payment or post-payment review process. The court only tangentially addressed many of the other issues raised by CalTax, as well as the standing issue raised by the FTB.

On a positive note for taxpayers, section 19138 was recently amended to make it somewhat less expansive. California Senate Bill 858, enacted on October 19, 2010, amended section 19138 by providing that the penalty only applies to an understatement of tax if such understatement exceeds the *greater* of (1) one million dollars, or (2) twenty percent of the tax shown on an original return (or on an amended return filed on or before the original or extended due date of the original return). These amendments were effective immediately and are operative for taxable years beginning on or after January 1, 2010.

**If you have any questions or would like further information on these developments, please contact Morrison & Foerster’s Sacramento State & Local Tax Group:**

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