

## Legal Updates & News

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## Current California “Strict Liability” Penalty Issues Under Revenue and Taxation Code Sections 19777.5 and 19138

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While California’s current \$26 billion budget crisis and recent legislative enactments, such as elective single factor sales and unitary credits,<sup>[1]</sup> have been the most prominent issues on the California tax front, two important and continuing penalty issues should not be overlooked. This article provides a brief update on the current status of both the 2004 so-called “amnesty interest penalty” and the 2008 underpayment penalty, both of which are imposed on a strict liability basis. Continuing, viable issues surround both penalties.

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### Section 19777.5

The amnesty interest penalty found in California Revenue and Taxation Code<sup>[2]</sup> section 19777.5 was enacted in 2004 as part of a Legislative package (SB 1100) which created tax amnesty programs to be administered by both the California State Board of Equalization (the “SBE”) and the California Franchise Tax Board (the “FTB”).<sup>[3]</sup> In general, section 19777.5 imposed a penalty for each taxable year for which amnesty could have been requested (i.e., tax reporting periods beginning before January 1, 2003), for amounts that were due and payable as of March 31, 2005, equal to fifty percent of the accrued interest otherwise due as of that date. The only statutory ground for claiming a refund of the 19777.5 penalty is that it was not “properly computed.”<sup>[4]</sup> The FTB received approximately \$3.5 billion in protective claims by March 31, 2005, as a result of taxpayers making protective payments to avoid the penalty for back years. However, it is estimated that only five percent, or \$180 million, was “new” revenue, with the balance being accelerated revenue or being refunded to taxpayers.<sup>[5]</sup>

The FTB continues to take the position that a taxpayer cannot file a protest of the section 19777.5 amnesty penalty before payment and that a post-payment challenge, e.g., a refund claim, only may be based on the ground the penalty was not accurately computed.<sup>[6]</sup> Similarly, the SBE in its adjudicatory role of reviewing decisions by the FTB on protests and refund claims consistently has taken the position that its jurisdiction to review the amnesty penalty is limited to situations where the penalty is assessed and paid, the taxpayer has filed a timely appeal from a denial of a refund claim, and the taxpayer

attempts to show a computational error in the penalty.<sup>[7]</sup>

Nevertheless, a taxpayer may challenge the constitutionality of section 19777.5. The fact that SB 1100 went into immediate effect and imposed increased interest, retroactively, in the form of a “penalty,” raises a number of interesting legal issues. State or federal constitutional challenges may lie on due process, equal protection, retroactivity, and/or ex post facto grounds. However, neither the FTB nor the SBE, as administrative agencies, has the power to refuse to enforce any of the provisions of SB 1100 on the grounds that they are unconstitutional, absent a precedential decision of the California courts.<sup>[8]</sup> Thus, meaningful challenges to the amnesty interest penalty must take place in the courts rather than before the administrative agencies.

Although the penalty was the result of legislation dating to 2004, there is still no definitive California Court of Appeal ruling on the constitutionality of the penalty. Many practitioners expected resolution of the issue in *General Electric Company*, which was filed in February 2006.<sup>[9]</sup> However, that case involved a prepayment challenge to the penalty, the FTB was (twice) successful on demurrer, and the case ultimately settled. Currently, there are a number of cases pending in the California courts which challenge the imposition of the 19777.5 penalty,<sup>[10]</sup> but there is not yet a precedential Court of Appeal decision.

Knowing that several pending court cases involve a challenge to the penalty, the FTB currently allows taxpayers to protect the statute of limitations on a refund claim by filing a request with the FTB to withhold any action on the claim while an audit determination, legislation, or litigation is still pending. Taxpayers who wish to file such protective claims should send a letter to the FTB identifying the tax year, the amount of amnesty penalty paid, and a statement requesting that the FTB hold the claim in abeyance pending the outcome of the litigation.<sup>[11]</sup>

### **Section 19138**

In 2008, SBX1 28<sup>[12]</sup> added section 19138, which imposed a new penalty, equal to 20% of the understatement of tax, on taxpayers subject to the Corporation Tax Law with understatements of tax in excess of one million dollars in any taxable year.<sup>[13]</sup> In the words of the FTB, this is a new “strict liability penalty”<sup>[14]</sup> with no discretion given to the FTB whether to assess or forgo the penalty on such traditional grounds for relief as reasonable cause, substantial authority, or adequate disclosure.<sup>[15]</sup> 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.<sup>[16]</sup> For purposes of computing the twenty percent, “understatement of tax” means the amount of tax shown on an original return or shown on an amended return filed on or before the original or extended due date of the return for any taxable year.<sup>[17]</sup> The penalty applies to taxable years beginning on or after January 1, 2003, for which the statute of limitations on assessments has not expired.<sup>[18]</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, was treated as the amount of tax shown on an original return for purposes of section 19138.<sup>[19]</sup>

The section 19138 penalty generated much activity at the FTB, which resulted in a December 5, 2008, Interested Parties Meeting, a March 23, 2009, Interested Parties Meeting, issuance of FTB Legal Notice 2009-03 (Mar. 27, 2009), and the penalty having its own dedicated portion of the FTB’s website.<sup>[20]</sup> The FTB reported in June 2009, that, as a result of the May 31st deadline for filing amended returns for the relevant back years, the new penalty resulted in \$2.7 billion of revenue, which was significantly higher (i.e., nearly twice) than the FTB’s estimate of \$1.4 billion.<sup>[21]</sup>

For a number of reasons, the new section 19138 penalty should continue to be of interest to all large California corporate taxpayers. First, this penalty will continue to be an issue each year in perpetuity unless and until it is repealed by the Legislature or struck down by a court. Accordingly, corporate taxpayers should pay particular attention to possible penalty exposure when filing future returns.

Second, there is pending litigation regarding the constitutionality of the statute. On February 17, 2009, a petition for writ of mandate was filed in *California Taxpayers’ Association v. California Franchise Tax Board*,<sup>[22]</sup> which challenged the constitutionality of section 19138. The petition set forth six causes of action, including claims that: (1) section 19138 is a “tax” (not a penalty) which under Article XIII, section

3, of the California Constitution, must be passed by at least a two-thirds vote of the Legislature, but which passed the Legislature by only a majority vote; (2) the bill (i.e., SBX1 28) was not properly read, printed, and distributed prior to vote, in violation of Article IV, section 8(b), of the California Constitution; (3) the section violates the Excessive Fines Clause of the Eighth Amendment of the U.S. Constitution; (4) the section violates the substantive due process guarantees of the Fourteenth Amendment because it is vague and retroactive; (5) the section violates procedural due process guarantees of the Fourteenth Amendment because it affords no prepayment or postpayment review; (6) the section violates the Commerce Clause of the U.S. Constitution because its practical effect is to discriminate against multistate corporations; and (7) the section violates the Equal Protection Clause of the U.S. Constitution because it arbitrarily discriminates against interstate businesses in favor of intrastate businesses.

The petition asked the trial court to issue a writ of mandate commanding the FTB to cease enforcing section 19138, a declaration that section 19138 was unconstitutional, and an injunction prohibiting the FTB from enforcing it. The petition 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 to avoid the penalty.<sup>[23]</sup> Following lively and protracted proceedings, the trial court, in a ruling filed on May 20, 2009, denied the petition for mandate and for other relief. On August 13, 2009, California Taxpayers' Association filed a notice of appeal with the Third District Court of Appeal.<sup>[24]</sup>

Third, there is possible Legislative action on the penalty statute. Assembly Bill 697 (C. Calderon) was amended on June 1, 2009, to limit the imposition of the section 19138 penalty to taxable years beginning before January 1, 2008 (and after January 1, 2003), and would repeal the penalty provisions on December 1, 2010. The FTB has currently scored AB 697 as having a revenue loss of \$580 million in the first year, i.e., 2008-2009—a dramatic change from its prior estimate of a first year revenue loss of only \$105 million.<sup>[25]</sup> AB 697 is currently on the suspense file in the Senate Revenue and Taxation Committee.

Fourth, taxpayers who filed amended returns by May 31, 2009, to avoid the penalty for taxable years beginning before January 1, 2008—and paid approximately \$2.7 billion to the FTB during that exercise—should remember to timely file refund claims meeting the requirements of section 19322 seeking a refund of amounts paid on those amended returns. The refund claims should not only seek a refund on the substantive grounds which led to the payments on the amended return, but also should allege the unconstitutionality of the statute, e.g., on all the grounds advanced in the pending *California Taxpayers' Association* appeal. While there are many potential statutes of limitation for filing refund claims, one such statute of particular application is section 19306, which provides in pertinent part that a refund claim can be filed within one year from the date of the overpayment.

“The purpose of a penalty is to deter wilful conduct considered undesirable.”<sup>[26]</sup> Yet twice in the past five years the California Legislature has enacted so-called “penalties” which by their terms retroactively “deter” conduct while generating and accelerating revenue. Both sections 19777.5 and 19138 should be closely watched by practitioners and corporations in hopes that relief is forthcoming from either the courts or the Legislature.

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## Footnotes

<sup>[1]</sup> See Eric J. Coffill and David A. Ziring, *The Income Tax Provisions of California's Fiscal 2009 Budget Act*, St. Tax Notes, Oct. 27, 2008, at 221-26.

<sup>[2]</sup> All statutory references herein are to the California Revenue and Taxation Code.

<sup>[3]</sup> For an expanded discussion of the enactment of SB 1100 and the amnesty programs, see Eric J. Coffill and Carley A. Roberts, *California Enacts New FTB and BOE Penalties Affecting Pending Audits, Protests, Appeals, and Settlements*, St. Tax Notes, Aug. 23, 2004, at 601-04.

<sup>[4]</sup> Section 19777.5(e)(2).

<sup>[5]</sup> See Cal. Franchise Tax Bd., AB 1452 – Bill Analysis, at 11 (Sept. 29, 2008). Of the \$3.5 billion in

protective claims received by the FTB, about \$3 billion was attributable to 109 taxpayers. The FTB in 2005 worked on a “fast-track” timetable to resolve as many amnesty-related refund claims as possible. See Cal-Tax, *Cal-Taxletter*, Oct. 14, 2005, at 7.

[6] See Cal. Franchise Tax Bd., *Administrative remedies if the post amnesty penalty is miscalculated*, Tax News, June 2006, at 2, available at <http://www.ftb.ca.gov/professionals/taxnews/0606/0606.pdf>.

[7] See, e.g., *Appeal of Virginia M. Harp*, No. 405941, 2009 Cal. Tax LEXIS 160 (State Bd. of Equalization Apr. 15, 2009); *Appeal of Kris Christianson and Carolyn Christianson*, No. 395923, 2009 Cal. Tax LEXIS 147 (State Bd. of Equalization Apr. 15, 2009).

[8] Cal. Const. art. III, § 3.5.

[9] *General Electric Co. and Subsidiaries v. Cal. Franchise Tax Bd.*, No. A115530 (Cal. App. 1st Dist. filed Sept. 15, 2006).

[10] Current pending cases include *Microsoft Corp. v. Cal. Franchise Tax Bd.*, No. CGC08471260 (Super. Ct. S.F. County filed Jan. 22, 2008); *River Garden Retirement Home v. Cal. Franchise Tax Bd.*, No. A123316 (Cal. App. 1st Dist. filed Nov. 6, 2008); and *Shaw v. Cal. Franchise Tax Bd.*, No. BC378829 (Super. Ct. L.A. County filed Oct. 10, 2007).

[11] Cal. Franchise Tax Bd., *The amnesty penalty and protective claims*, Tax News, June 2007, at 2, available at <http://www.ftb.ca.gov/professionals/taxnews//2007/0607/0607.pdf>.

[12] The bill was signed by the Governor on October 1, 2008. For an expanded discussion of the enactment of SBX1 28 and section 19138, see Eric J. Coffill and David A. Ziring, *The Income Tax Provisions of California's Fiscal 2009 Budget Act*, St. Tax Notes, Oct. 27, 2008, at 221-26.

[13] Section 19138(a)(1), (b).

[14] Cal. Franchise Tax Bd., SBX1 28 – Bill Analysis, at 9 (Sept. 29, 2008).

[15] There are, technically speaking, a few exceptions to the penalty, which are as follows: A refund or credit for any amounts paid to satisfy the new penalty may be allowed only on the grounds that the amount of the penalty was not properly computed by the FTB. Section 19138(e). However, the penalty may not be imposed on any understatement to the extent the understatement is attributable to a change in law that is enacted, promulgated, issued, or becomes final after the earlier of (1) the date the taxpayer files the return for the taxable year for which the change is operative; or (2) the extended due date for the return of the taxpayer for the taxable year for which the change is operative. Section 19138(f)(1). For this purpose, “change of law” means a statutory change or an interpretation of law or rule of law by regulation, legal ruling of counsel under Government Code section 11340.9, or a published federal or California court decision. Section 19138(f)(2). The FTB is directed to implement this latter provision “in a reasonable manner.” Section 19138(f)(3). In addition, no penalty will be imposed to the extent the understatement is attributable to the taxpayer’s reasonable reliance on written advice of the FTB, but only if the written advice was a Chief Counsel legal ruling issued under section 21012(a)(1). Section 19138(g).

[16] Section 19138(a)(2).

[17] Section 19138(b).

[18] Section 19138(h).

[19] Section 19138(b).

[20] See [http://www.ftb.ca.gov/businesses/large\\_corporate\\_understatement\\_penalty.shtml](http://www.ftb.ca.gov/businesses/large_corporate_understatement_penalty.shtml).

[21] Cal-Tax, *Cal-Taxletter*, June 19, 2009, at 9.

[22] No. 2009-80000168 (Super. Ct. Sacramento County filed Feb. 17, 2009).

[23] For more information on the case, see Jennifer Carr, *California Taxpayer Group Fights New Understatement Penalty*, St. Tax Notes, Mar. 9, 2009, at 785-89.

[24] No. C062791 (Cal. App. 3d Dist. filed Aug. 13, 2009).

[25] Cal. Franchise Tax Bd., AB 697 – Revised Amended Bill Analysis, at 2 (July 7, 2009).

[26] *Fran Corp. v. United States*, 998 F. Supp. 296, 299 n.4 (S.D.N.Y. 1998).