STATE+LOCAL TAX
INSIGHTS

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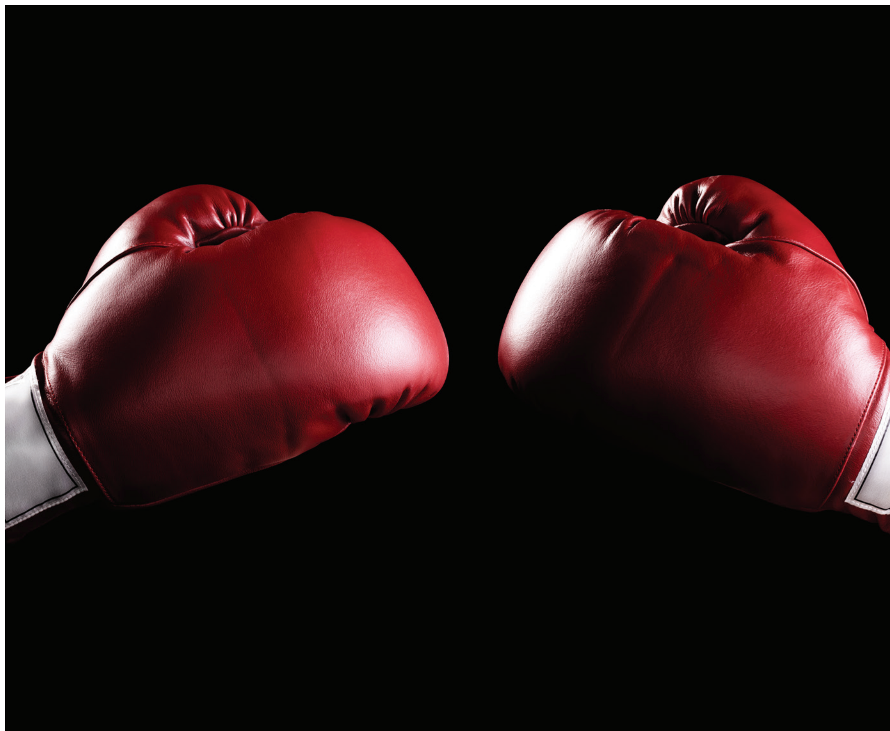

PENALTIES: YOU CAN WIN

By Mitchell A. Newmark and Michael P. Penza

Penalties pose unique problems that are not directly associated with tax assessments. Over 90 years ago, the U.S. Supreme Court stated that, while interest is a form of compensation, penalties are a form of punishment.[1] Further, penalties themselves imply wrongdoing or conduct outside legal boundaries.[2]

An assessment of penalties may harm a business' reputation more than an assessment of tax. The same may be true for the reputation of the business' tax folks—within the business itself. Further, a dollar of penalty is more expensive than a dollar of tax. Whereas state taxes are deductible for federal income tax purposes, penalties may not be deductible.[3]

Unfortunately, states are imposing penalties with increasing frequency. This is hardly surprising. Given the politically unpalatable nature of tax increases coupled with budgetary shortfalls, nontax sources of revenue have become increasingly important to the fiscal health of many states.

continued on page 2

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Considering their revenue-raising importance, do not expect a waiver of penalties without a fight. Some states provide discretionary authority to impose (or not impose) penalties. Conversely, some state statutes automatically impose penalties on an underpayment of tax. However, such statutes should grant the taxing authority discretion to waive the penalties if the company demonstrates that the underpayment was due to reasonable cause. More recently, taxing authorities have become increasingly reluctant to exercise their discretion to waive penalties. If the taxing authorities do not remove the penalties, don't go down without a fight. There are several arguments with which you can arm yourself to beat back penalties. A couple follow.

CASES OF FIRST IMPRESSION

One such argument is that penalties are inappropriate in cases of first impression. We successfully raised this argument before the New Jersey Supreme Court in *United Parcel Service General Services Co. v. Director, Division of Taxation* ("*UPS*").[4] In that case, the State assessed tax and penalties based on its position that a cash management system constituted loans upon which interest must be imputed for income tax purposes. The New Jersey Supreme Court agreed with us that the State abused its discretion by refusing to waive the penalties because no directly pertinent legal authority existed on the tax issue and the company had shown reasonable cause for the underpayment of its tax liability.

Unfortunately, other state courts have failed to adopt the sensible approach articulated in *UPS*. In *Fisher Broadcasting Company v. Department of Revenue*,[5] the Oregon Tax Court held that a taxpayer's gain from the sale of stock was apportionable business income because the stock was used to obtain financing for its business operations. The court then upheld the imposition of penalties, even though the court acknowledged that the tax issue was of a constitutional dimension with no precedent directly on point. In *Target Brands, Inc. v. Department of Revenue*,[6] a Colorado trial court recently held that a corporation with no physical presence in Colorado had nexus with the State for purposes of the corporate income tax. The court also upheld the imposition of penalties, even though the court acknowledged that the tax issue was of a constitutional dimension that had created "a split in legal authority" among the States. In both *Fisher Broadcasting* and *Target Brands*, the companies were unjustifiably penalized for taking reasonable positions on constitutional issues of first impression in those respective States. Those cases were trial court decisions that are not binding on the States' high courts. Hopefully, the States' high courts would not approve.

Some states will assert that they waive penalties on cases of first impression only if the company's position is the most reasonable position—*i.e.*, that the company's position as to the tax issue is correct. However, if the company's position is correct, no tax is owed. If no tax is owed, then (typically) no penalties are owed because

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continued on page 3

most penalties are a percentage of the tax. If penalties are waived only when a taxpayer pays the correct amount of tax, the state would never waive penalties because there would be no penalties to waive. It follows that situations must exist in which a company owes tax but the state must exercise discretion to waive penalties. A failure to do so may suggest an abuse of discretion. There is simply no place in fair tax administration for penalties on issues of first impression.

DUE PROCESS

A company that is assessed penalties could consider an argument based on the federal Due Process Clause. In *McKesson Corporation v. Division of Alcoholic Beverages and Tobacco*,[7] the U.S. Supreme Court held that the Due Process Clause of the U.S. Constitution requires a state to provide procedural safeguards to ensure against the unlawful exaction of a tax. This stems from the long-standing recognition that the "power to the tax involves the power to destroy."[8]

Among the procedural safeguards required, a state must provide either a predeprivation process—*i.e.*, allow the company to challenge the tax before it is paid—or a postdeprivation process—*i.e.*, allow the company to challenge the tax after it is paid.[9] However, if a state coerces a company into paying a tax through the threat of penalties for nonpayment, then the state has not provided predeprivation process.[10] It, therefore, must provide postdeprivation process—*i.e.*, a refund claim.[11]

The threat of penalties to induce a payment of tax prior to challenge is coercive and the predeprivation process is denied. Accordingly, taxpayers should consider a Due Process challenge any time they are barred from bringing a refund claim.

The foregoing is illustrated by the interplay between California's Large Corporate Understatement Penalty ("LCUP") and California's repeal of the Multistate Tax Compact ("Compact"). The LCUP imposes a strict liability non-waivable penalty equal to 20% of an understatement of tax if the understatement exceeds a certain threshold.[12] In 2012, the California Legislature repealed the Compact, including its apportionment election, while simultaneously asserting that California adheres to the doctrine of election.[13] The doctrine of election provides that elections made on original returns are binding (and such elections cannot be made on an amended return).[14] As a result, California presented taxpayers with two options: (1) make the Compact apportionment election on an original return and incur any LCUP on the assessment of tax; or (2) make the Compact election on an amended return and fight the State's assertion of the doctrine of election.

This coercive process is unconstitutional. California coerced taxpayers into paying a tax computed without the Compact election through the threat of the LCUP, therefore providing no predeprivation process. California then prevented taxpayers from filing refund claims to take the Compact election, therefore providing no postdeprivaton process. There is no place under due process of law for penalties that cannot be avoided by maintaining your rights under the law in good faith.

Amnesty penalties may also raise Due Process concerns. Tax amnesty statutes generally allow companies to pay their outstanding tax liabilities without incurring interest and penalties that would otherwise be due (or by providing a break on interest and penalties). However, such statutes may also impose new penalties on companies that do not participate in the amnesty. If this is the case, companies must be able to claim refunds for taxes paid under amnesty or be able to maintain challenges without new penalties. A state that coerces a company into participating in an amnesty program through the threat of penalties, but does not provide the company the opportunity to challenge the exaction after the tax is paid, denies the company its Due Process. Good faith challenges against taxing authorities must be permitted to proceed without threat of new penalties for challenging the tax authority.

If you are assessed penalties, increasingly you will have to push back. Don't go down without a fight.

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1. *U.S. v. Childs*, 266 U.S. 304, 307 (1924).
2. *Black's Law Dictionary*, p. 1313 (10th ed. 2014).
3. I.R.S. Pub. 535, p. 46 (Jan. 19, 2017).
4. 103 A.3d 260 (N.J. 2014).
5. 22 OTR 69 (Or. T.C. 2015).
6. No. 2015CV33831 (Colo. Dist. Ct. Jan. 27, 2017).
7. 496 U.S. 18, 36 (1990).
8. *McCulloch v. Maryland*, 17 U.S. 316, 431 (1819).
9. *McKesson Corp.*, 496 U.S. at 36–37.
10. *Id.* at 37–38.
11. *Id.* at 39.
12. Cal. Rev. & Tax. Code § 19138(a) & (b)(1).
13. S.B. 1015, 2012 Leg., Reg. Sess. §§ 3 & 4 (Cal. 2012).
14. S.B. 1015, 2012 Leg., Reg. Sess. § 4 (Cal. 2012).

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber, or comment on this newsletter, please write to Nicole L. Johnson at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email her at njohnson@mofo.com, or write to Rebecca M. Balinskas at Morrison & Foerster LLP, 250 West 55th St., New York, New York 10019, or email her at rbalinskas@mofo.com.

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