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CA's 20% LCUP Penalty Shouldn't Apply to Compact Elections Under Gillette

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Friday, Reed Smith partner and former FTB Chief Counsel Brian Toman submitted a written request for consideration at the FTB's meeting yesterday for the FTB to interpret the 20 percent Large Corporate Understatement Penalty (LCUP) to not apply to taxpayers that elect to use the Multistate Tax Compact method on their 2011 tax returns. The language of the letter is included in this alert. Regardless of the FTB's reaction to Reed Smith's request, we believe that the LCUP should not apply and that, if the Compact election is sustained, California's attempt to withdraw from the Compact under SB 1015 should be determined to be invalid. Thus, taxpayers who benefit from the election should seriously consider making the election on their upcoming 2011 returns.

> Dear Honorable Members of the Franchise Tax Board:
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> We are submitting these materials as they relate to Item 4 of the publicly noticed agenda for the Franchise Tax Board's meeting on September 5, 2012. We do so because the interaction between the Multistate Tax Compact (the "Compact"), Senate Bill 1015, Proposition 26, and the Large Corporate Understatement Penalty may be interpreted to create an unfair situation in which California taxpayers may be given a choice between losing their rights under the Compact or being subject to severe penalties. This places taxpayers "between a rock and a hard place" in a way that may violate California taxpayers' due process rights that may be resolved with simple guidance interpreting the interplay of these laws.
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> **The Rock: Senate Bill 1015**
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> Before a California Court of Appeal issued a decision in *Gillette*,[1] which upheld a taxpayer's right to elect to apportion income for California income and franchise tax purposes based on the Compact, the Legislature passed, by majority vote, Senate Bill ("SB") 1015. The *Gillette* decision was later vacated and the matter is currently pending before the Court of Appeal, leaving California taxpayers with no current statement on the law, and therefore uncertain as to their legal rights.
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> As the FTB is aware, SB 1015 purports to repeal the Compact and also provides that taxpayers must make elections affecting the computation of tax on original timely filed returns for all tax years. Thus, SB 1015 ostensibly limits the impact of Gillette by prohibiting future Compact elections, as well as by by prohibiting Compact elections for past years that had not already been taken on original returns.

However, the validity of SB 1015—and the withdrawal from the Compact in particular—is suspect. SB 1015 was passed by a simple majority and not the two-thirds majority that is required for tax increases by Article XIIIA, Section 3 of the California Constitution ("Proposition 26"). Proposition 26's two-thirds majority requirement applies to "Any change in state statute which results in any taxpayer paying a higher tax."[2] It is clear that if the courts in *Gillette* ultimately determine that taxpayers are entitled to an election under the Compact and were entitled to an election under the Compact as of the date SB 1015 was enacted, the repeal of such election would be a "tax increase" under Proposition 26. The repeal of any alternative tax calculation meets that simple criterion. Accordingly, we believe that it is likely that a court would conclude that the Legislature's attempted withdrawal from the Compact through SB 1015 is invalid, and the Compact election remains available.

A similar argument can be made with respect to another component of SB 1015—the requirement that an election affecting the computation of tax be made on an original and timely filed return known as the "Doctrine of Election." However, whether the Doctrine of Election, as enacted, would be invalidated under Proposition 26 or on any other constitutional grounds, is distinct from whether SB 1015's withdrawal from the Compact is valid. Unless and until the Doctrine of Election is overturned, either in some phase of the Gillette litigation, or in some other action, a prudent taxpayer must recognize its presumptive validity.

As such, that same prudent taxpayer would avail itself of the Compact method by making its election on an original, timely filed return, rather than risking the loss of the benefit of the election. However, for the reasons that follow, making that election may create exposure for taxpayers under an aggressive FTB interpretation of the Large Corporation Understatement Penalty ("LCUP").[3]

The Hard Place: Large Corporate Understatement Penalty

The LCUP is a 20% penalty that applies to understatements of tax of the greater of $1 million or 20% of the tax shown on an original, timely filed return. What makes the LCUP different from other penalties is that it is a "strict liability" penalty: it is a penalty that applies mechanically if an understatement is shown, regardless of intent, negligence, reasonable cause, or reasonable reliance on opinion of counsel. Thus, even if taxpayers relied on the initial opinion issued by the California Court of Appeal in *Gillette* stating that the Compact election is valid, an unreasonable interpretation of the LCUP may still subject taxpayers to the penalty if the courts ultimately conclude that the Compact election is not valid.

In sum, because of the presumptive validity of the Doctrine of Election, as discussed above, taxpayers who would prefer to avoid LCUP exposure by filing an amended return—as they may in other situations—would risk losing the Compact election altogether by doing so. Forcing taxpayers to choose between losing a likely benefit and facing penalty exposure would be bad tax policy. On the other hand, a reasonable FTB interpretation of the interplay of these different provisions would avoid this dilemma.

The Solution

Although the LCUP is a strict liability penalty, it does provide an exception that appears to be intended for situations just like this. Section 19138(f) provides, in pertinent part, as follows:

> (1) No penalty shall be imposed…on any understatement to the extent that the understatement is attributable to a change in law that…becomes final after the earlier of either of the following dates:
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> > (A) The date the taxpayer files the return for the taxable year for which the change is operative.
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> > (B) The extended due date for the return of the taxpayer for the taxable year for which the change is operative.
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> (2) For purposes of this subdivision, a "change of law" means a statutory change **or an interpretation of law** or rule of law **by…a published…California court decision**.
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> (3) **The Franchise Tax Board shall implement this subdivision in a reasonable manner.**

(Emphasis added.)

This statutory exception permits the FTB, in reasonable circumstances, to avoid unfair application of the LCUP for taxpayers that understate their tax due to a "change in law" effective after the date on which the return was filed. The Legislature defined a "change in law" to include "an interpretation of law or rule of law by…California court decision." Thus, replacing the term "change in law" with the pertinent parts of its definition, this statutory exception applies "to the extent that the understatement is attributable to *an interpretation of law…by…California court decision*…that becomes final" after the taxpayer files its return. In this case, a taxpayer's Compact election may result in the taxpayer paying less tax than it otherwise would; that tax amount would become an understatement only after the final holding of the courts on the Compact issue. That is, the understatement would only arise as the result of a later "change of law," as that term is defined by statute. Thus, the exception should apply to all returns that are filed before the final holding of the courts on this issue.

Additionally, although we see no ambiguity in the statute, if one existed, it must be interpreted in favor of the taxpayer. In *River Garden Retirement Home v. FTB*,[4] a California Court of Appeal made clear that uncertainty in a statute imposing penalties should be strictly construed in favor of the taxpayer. Further, in *Edison California Stores*,[5] the California Supreme Court stated, "In case of doubt, construction is to favor the

taxpayer rather than the government." Thus, even if our interpretation above was not the only one, the above interpretation must be accepted.

From a policy perspective, the exception to the LCUP is designed to avoid the application of a penalty to an understatement attributable to unsettled law that becomes settled after the return is filed. This dilemma is exactly the kind of situation that calls for the FTB to "implement" the exception "in a reasonable manner."

Under this reasonable interpretation of the LCUP exception, California taxpayers who file their calendar year 2011 tax returns that are due October 15 using the Compact method should not be subject to the LCUP if the courts later determine that California taxpayers were in fact not permitted to take the Compact election. This interpretation makes sense (taxpayers would be filing based on the most recent statement of the law). It would also, as described next, protect the LCUP from a due process challenge. (This is the only interpretation that provides a reasonable pre-deprivation remedy by permitting taxpayers to file under the Compact.) Finally, it would be consistent with the Legislature's intent to implement the LCUP exception in a reasonable manner.

In light of the upcoming October 15 deadline before which taxpayers must file California income and franchise tax returns, we believe that the FTB should assure taxpayers that it will apply the LCUP and LCUP exception in a reasonable manner and will not punish taxpayers who choose to elect the Compact method while this area of the law is in limbo.

The Due Process Clause Violation

If the LCUP were not interpreted as described above, California taxpayers would be left without a clear course of action. On the one hand, they can elect the Compact on their returns and risk the LCUP. On the other hand, they can wait and elect the Compact on refund claims or amended returns and risk not receiving the benefit of the Compact.

Construing the relevant provisions in a manner that creates this dilemma would violate the Due Process Clause under the FTB's own interpretation of the LCUP that was accepted by a California Court of Appeal. In recent years, the FTB prevailed in a case at the Court of Appeal in which the taxpayer challenged the constitutionality of the LCUP. The LCUP survived this challenge because the FTB showed that California taxpayers had an adequate post-deprivation remedy in the form of a refund action in Superior Court.[6] The FTB stated, "Petitioner's procedural due process challenge to section 19138 must fail because California Franchise and Income Tax Law provides a constitutionally adequate post-deprivation remedy in the form of a refund suit in the superior court." Also, citing *McKesson Corp. v. Div. of Alcohol Bevs. & Tobacco*,[7] the FTB stated, "California's Franchise and Income Tax Law provides Petitioner 'with all of the process it is due: an opportunity to contest the validity of the tax and a clear and certain remedy designed to render the opportunity meaningful by preventing any permanent unlawful deprivation of property.'" In other words, the FTB argued that taxpayers could sidestep LCUP exposure by paying the tax and suing for a refund in court. The Court of Appeal accepted this argument and held that the LCUP did not violate the Due Process Clause.[8]

Here, paying the tax and filing a refund claim to elect the Compact method is not an option since SB 1015 requires the Compact election be made on an original return. This eliminates the only post-deprivation remedy on which the FTB relied when it argued that the LCUP should be upheld. That remedy—filing a refund suit—would require a taxpayer to overpay its tax and file a claim for refund.[9] For Compact purposes, it is on that claim for refund that a taxpayer would make its Compact election to "contest the validity of the tax." Of course, under the election requirement of SB 1015, such an election would be too late because a taxpayer could no longer make the Compact election. Thus, taxpayers would be deprived of the only pre- or post-deprivation remedy previously available to them.

Statutes must be harmonized with federal and state constitutional provisions whenever possible.[10] As the Court of Appeal stated in the *California Taxpayers' Association* case, with specific reference to the LCUP:

[U]nder the legal principles that guide our review, if a statute is susceptible of two constructions, one of which is constitutional and the other not, we will go with the constitutional one even though the unconstitutional construction is equally reasonable given the statute's language. And, a "statute will not be invalidated if it is readily susceptible to a narrowing construction that would make it constitutional."

(Citations omitted.)

To avoid conflict with the Due Process Clauses of the United States and California Constitutions, the LCUP must be interpreted to not apply to a taxpayer that makes the Compact election.

In conclusion, we respectfully request the FTB to notify taxpayers that it will not impose the LCUP upon taxpayers who elect the Compact method on original, timely filed returns pending the final resolution of these issues in court. Such a result would comport with principles of fair and reasonable tax administration, and would ensure compliance with due process requirements.

Sincerely,

Brian Toman

If you have questions about the election to use the Multistate Compact apportionment method or the LCUP, please contact the authors of this article, or the Reed Smith lawyer with whom you usually work. For more information on Reed Smith's California tax practice, visit www.reedsmith.com/catax.

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[1] *The Gillette Company & Subs. v. California Franchise Tax Board*, CA. Ct. App., 1st Dist., Dkt. No. A130803 (decision issued July 24, 2012 and vacated August 9, 2012); *appeal from* SF Sup. Ct. Dkt. No. CGC-10-495911.
[2] Calif. Const. Art. XIII A, § 3(a).

[3] Revenue and Taxation Code § 19138.
[4] *River Garden Retirement Home v. Franchise Tax Board*, 186 Cal.App.4th 922 (2010), citing *Waterman Convalescent Hospital, Inc. v. Jurupa Community Services Dist*., 53 Cal.App.4th 1550 (1996).
[5] *Edison California Stores, Inc. v. McColgan*, 30 Cal.2d 427 183.
[6] *See* Amended Opposition to Petition and Complaint, Pages 17-19.
[7] 496 US 18 (1990).
[8] *California Taxpayers' Association v. FTB*, 190 Cal.App.4th 1139 (Cal. Ct. App. 3rd App. Dist. 2010).
[9] See Rev. & Tax. Code § 19382 ("Except as provided in Section 19385, after payment of the tax and denial by the Franchise Tax Board of a claim for refund, any taxpayer claiming that the tax computed and assessed is void in whole or in part may bring an action, upon the ground set forth in that claim for refund, against the Franchise Tax Board for the recovery of the whole or any part of the amount paid.").
[10] If the terms of a statute are, by fair and reasonable interpretation, capable of a meaning consistent with the requirements of the Constitution, the statute is given that meaning, rather than one in conflict with the Constitution. *Los Angeles County v. Riley* (1936) 6 Cal.2d 625, 629 (1936).