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February 24, 2011

Honorable Tani Cantil-Sakauye, Chief Justice
and the Associate Justices
Supreme Court of California
350 McAllister Street
San Francisco, California 94102-4797

Re: **Supreme Court Case No. S189996**

CALIFORNIA TAXPAYERS' ASSOCIATION v. FRANCHISE TAX BOARD

Dear Chief Justice Cantil-Sakauye and Associate Justices:

On behalf of Tax Executives Institute, I write to urge the Court to grant the pending Petition for Review by the California Taxpayers' Association in Supreme Court Case No. S189996. The case presents important constitutional and tax policy issues affecting business taxpayers – namely, the limits imposed by the Due Process Clause of the Fourteenth Amendment to the United States Constitution on California's ability to impose a retroactive strict liability assessment without providing taxpayers a mechanism to obtain a refund. A decision by the Court will provide much needed certainty about the validity of Revenue & Taxation Code section 19138, a provision with significant financial implications for businesses with operations in California.

I. Interest of the Applicant

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including several in California. Our nearly 7,000 members represent 3,000 of the largest companies in the world, many of which are either resident or do business in California. As the preeminent association of business tax professionals worldwide, TEI is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Due Process Clause and other constitutional rights of all business taxpayers. As tax professionals who recognize the states' right to collect properly levied taxes and who respect the legitimacy of state assessments, TEI members have a significant interest in ensuring that state tax provisions comply with the protections accorded by the federal constitution.

II. Why Review Should be Granted

A. Background

Enacted in 2008, Revenue & Taxation Code section 19138 imposes a 20% penalty for all understatements of California corporate income tax in excess of $1 million.[1] This penalty applies both prospectively and retroactively to open tax years back to 2003. Section 19138 also prohibits the issuance of a refund or credit for amounts collected under the penalty (other than in cases where the Franchise Tax Board improperly computes the penalty). Relying on a separate provision within the Revenue & Taxation Code, the Court of Appeal interpreted the statute's ban on refunds or credits to apply only to claims made at the administrative level and thus opened the door for taxpayers to challenge denied refund claims in court.[2] The statute relied upon by the lower court, however, requires that the taxpayer first apply to the Franchise Tax Board for consideration of its refund claim, *even though Section 19138 prohibits the Board from issuing a refund*.

B. Section 19138 Violates the Due Process Clause of the United States Constitution[3]

1. Remedy

The Court of Appeal's opinion warrants review because it raises a crucial legal issue – whether the refund remedy afforded taxpayers comports with Due Process, an issue of vital importance to TEI members and their employers, to California taxpayers, and to the State. The Court of Appeal's decision threatens to undermine the protections afforded to taxpayers by the Due Process Clause against states retaining improperly collected taxes and penalties. "To say that . . . [a] county [or State] could collect . . . unlawful taxes by coercive means and not incur any obligation to pay them back is nothing short of saying that it could take or appropriate the property of [the taxpayers] . . . arbitrarily and without due process of law." *Ward v. Love County Board of Commissioners*, 253 U.S. 17, 24 (1920).

The Court of Appeal found that Section 19138's prohibition on refunds violated federal constitutional due process protections, but it declined to strike the offensive language from the statute. Instead, it relied on an interpretation by the Franchise Tax Board that the prohibition only applies to the administrative level of the refund process, thereby supposedly curing the statute's constitutional infirmity. Nothing in the statute or its legislative history supports that interpretation. Indeed, Section 19138(d) clearly states that "[a] refund or credit for any amounts paid to satisfy a penalty imposed under this section may be allowed *only* on the grounds that the

[1] Effective October 19, 2010, the threshold for triggering the penalty is the greater of $1 million or 20% of the tax shown on the original or amended return.

[2] The opinion of the Court of Appeal, Third Appellate District is attached as Exhibit A to Petitioner's brief.

[3] The Petition ably describes the vital importance to Californians of the Proposition 13 issues raised in this case. Because TEI is a global organization, the Institute has focused this letter on the federal Due Process implications of the case.

amount of the penalty was not properly computed by the Franchise Tax Board." (Emphasis added).

Under the Court of Appeal's interpretation of Section 19138, taxpayers will be forced to participate in a potentially lengthy and expensive administrative process as a prelude to litigating their refund claims in court, even though the Franchise Tax Board is statutorily precluded from sustaining the taxpayer's position. Such a hollow "remedy" at once beggars both common sense and the requirements of the Due Process Clause. Indeed, the Supreme Court of the United States has clearly held that the process of challenging an assessment cannot be so burdensome that it offers no real opportunity to challenge its assertion. *McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 36 (1990). What's more, the Court of Appeal's interpretation would require the Franchise Tax Board to expend scarce state resources handling administrative appeals that it could not grant, thereby adding to the backlog of unresolved cases (currently in excess of $1 billion).

Tax Executives Institute's members and the businesses by which they are employed, as well as all California taxpayers, have a vital interest in ensuring the sufficiency and predictability of remedies accorded taxpayers subjected to invalid assessments of taxes and penalties. Unless reversed, this case will affect far more than the constitutionality of Section 19138; it will inevitably have a deleterious effect on the due process rights of taxpayers in California.

2. Retroactivity

Although the Supreme Court of the United States has countenanced retroactive legislation in the past, a legislature's power to enact retroactive laws is significantly circumscribed by the federal Constitution. To survive a challenge under the Due Process Clause, economic legislation – legislation affecting the economic rights or position of a party (such as tax legislation) – must "be supported by a legitimate legislative purpose furthered by rational means." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984). While "[r]etroactive application of revenue measures is rationally related to the legitimate governmental purpose of raising revenue," *United States v. Carlton*, 512 U.S. 26, 37 (1994) (O'Connor, J. concurring), the period of a statute's retroactivity must be "modest" for it to satisfy due process. *Id*. at 32 (majority opinion). "A period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise, in my view, serious constitutional questions." *Id*. at 38 (O'Connor, J. concurring).

Here, the Court of Appeal held that Section 19138 constituted a penalty and not a tax. While TEI disagrees with the finding, we submit that it puts the constitutionality of the provision's retroactive application even more in doubt. This is because courts have historically accorded greater deference to a legislature's purpose when the statute being applied retroactively is a tax than when it is a penalty. *See e.g., Licari v. Commissioner*, 946 F.2d 690 (9th Cir. 1991) (involving a due process challenge to the retroactive application of the substantial understatement penalty found in section 6661 of the Internal Revenue Code). When the Court of Appeal's characterization of the provision as a penalty is combined with the strict liability nature of Section 19138 (as well as the onerous mechanism for obtaining a refund of amounts paid), the lack of any legitimate legislative purpose for Section 19138 becomes manifest. In addition, the

five-year retroactive reach of Section 19138 exceeds any reasonable interpretation of the Due Process Clause's modesty standard, whereby a shorter period of retroactivity is more likely to be sustained than a longer, "immodest" one. A decision by this Court overturning the ruling below would vivify the constitutional due process restraints governing the enactment of retroactive laws.

If you have any questions about the Institute's views or desire additional information regarding the comments contained in this letter, please do not hesitate to contact Linda Dickens, Chair of TEI's State and Local Tax Committee, at 972.917.6912 (linda-dickens@ti.com) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

Respectfully submitted,
Tax Executives Institute, Inc.

Paul O'Connor
International President