

Client Alert.

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California Court of Appeal Permits Retroactive Taxes to Remedy Unconstitutional Discrimination; Upholds Post-Amnesty Penalty

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The California Court of Appeal, First Appellate District, recently issued an opinion against the taxpayer in *River Garden Retirement Home v. Franchise Tax Board*, 2010 Cal. App. LEXIS 1146 (2010). The case presented two primary issues, both of which may have important consequences for California taxpayers: (1) whether the Franchise Tax Board (the “FTB”) permissibly applied California’s post-amnesty penalty in section 19777.5 of the California Revenue & Taxation Code (“CRTC”); and (2) what is the appropriate remedy when a deduction is found to unconstitutionally discriminate against out-of-state entities in violation of the dormant commerce clause.

The Court of Appeal found the FTB’s imposition of the post-amnesty penalty to be permissible. CRTC section 19777.5 imposes a penalty against taxpayer that could have availed itself of the FTB’s 2005 amnesty program, but chose not to. The Court of Appeal found that the imposition of this penalty against the taxpayer in *River Garden* was proper because the taxpayer’s payment became “due and payable” following the taxpayer’s exhaustion of its administrative remedies, because the post-amnesty penalty does not operate retroactively (the Court found that the penalty was tied to the taxpayer’s current failure to avail itself of the amnesty program, and not its prior return position), and because the imposition of the penalty was not subject to the standard statute of limitations for deficiencies.

The remedies issue originated from the California Court of Appeal’s decision in *Farmer Bros. Co. v. Franchise Tax Board*, 108 Cal. App. 4th 976 (2003), which held that the dividends received deduction in CRTC section 24402 violated the dormant commerce clause because it permitted deductions for dividends received from corporations subject to taxation in California, but precluded deductions for dividends received from corporations not subject to California taxes. In response to the *Farmer Bros.* decision, the FTB took the position that it would permit dividends received deductions for tax years ending prior to December 1, 1999, but would disallow the dividends received deductions for all taxpayers for tax years ending on or after December 1, 1999. The question in *River Garden* was whether the FTB’s response to the decision in *Farmer Bros.* provided a clear and certain remedy for the constitutional violation, and whether the remedy itself was unconstitutional.

The Court of Appeal upheld the FTB’s method of remedying the constitutional violation in *Farmer Bros.* As an initial matter, the Court of Appeal, relying primarily on the recent decision in *Abbott Laboratories v. Franchise Tax Board*, 175 Cal. App. 4th 1346 (2009), concluded that it could neither sever the unconstitutional portion of the dividends received deduction (leaving the deduction available to all taxpayers), nor could it reform the statute to exclude the unconstitutional portion. The Court of Appeal then found that the FTB’s remedy of retroactively taxing the favored class (i.e., retroactively disallowing the deduction for taxpayers to which the dividends received deduction was previously available) for tax years ending after December 1, 1999 was constitutionally permissible because it placed all taxpayers on equal footing through

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the use of what the Court of Appeal deemed to be a modest period of retroactivity. Interestingly, in finding the several year period of retroactivity in this case to be “modest,” the Court of Appeal distinguished the relevant California case law, and instead relied on federal case law and case law from other jurisdictions to rule against the taxpayer. In so doing, the Court of Appeal relied on a facts and circumstances test to determine whether the period of retroactivity is sufficiently modest to be constitutional, focusing on factors such as:

- The purpose of the retroactive tax (in this case, to cure an unconstitutional violation);
- Whether statutory authority exists for the retroactive tax (in this case, the Court of Appeal surprisingly concluded that CRTC section 19393 unambiguously provided this authority);
- The nature of the retroactive tax itself (in this case, the retroactive imposition was the disallowance of a deduction, which the Court noted was a matter of legislative grace);
- Whether the retroactive imposition is within the statute of limitations (in this case, the period of retroactivity was apparently chosen to correspond to the statute of limitations);
- How promptly the taxing authority acted in imposing the retroactive tax as a remedy to the constitutional violation (in this case, the Court found that the FTB had acted promptly); and
- The burden placed on the taxpayer by the unconstitutional tax (the Court distinguished this case from *City of Modesto v. National Med., Inc.*, 128 Cal. App. 4th 518 (2005), in which the retroactive tax found to be impermissible would have required the taxpayer to produce documentation for up to nine years that it otherwise was not required to maintain).

After deciding that the retroactive elimination of the dividends received deduction satisfied the federal constitution, the Court of Appeal dismissed the taxpayer’s argument that the retroactive tax imposition was a tax increase that was not passed by a vote of at least two-thirds of the Legislature in violation of article XIII A, section 3 of the California Constitution. The Court of Appeal rejected this argument on the ground that article XIII A, section 3 applied only to Legislative enactments, and did not apply to tax increases as a result of policy directives.

This decision will become final at the expiration of the period in which the taxpayer may appeal the Court of Appeal’s decision, or following the resolution of any petition for review filed by the taxpayer. For more information on the issues raised in this decision, please contact Tom Steele, tsteele@mofo.com, Eric Coffill, ecoffill@mofo.com, Andres Vallejo, avallejo@mofo.com, Carley Roberts, croberts@mofo.com, or Scott Reiber, sreiber@mofo.com.

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