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California Tax Takes: A Tool To Fight Underpayment Penalties

By **Shail Shah, Priscilla Parrett, Michael Lurie and Yoni Fix** (August 19, 2019, 2:58 PM EDT)


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The recent U.S. Supreme Court decision in Timbs v. Indiana may open the door to taxpayer challenges to California's large corporate understatement penalty as an excessive fine under the Eighth Amendment to the U.S. Constitution. Additionally, the California Legislature is considering a bill that would expand the False Claims Act to include tax claims. If this bill passes, taxpayers will need to beware of litigation challenging return positions beyond the normal statutes of limitation that govern tax assessments.

1. An Argument That California's Large Corporate Understatement Penalty Is an Excessive Fine Under the Eighth Amendment

California's large corporate understatement penalty, or LCUP, is imposed on underpayments of corporate franchise tax if those underpayments exceed $1 million or 20% of the tax shown on the original return, at the rate of 20% of the underpayment.[1] The LCUP provides only a few limited exceptions: (1) changes in law,[2] (2) alternative apportionment,[3] (3) change in federal accounting method,[4] and (4) reliance on legal rulings by the Franchise Tax Board's chief counsel.[5] Unlike most accuracy-related tax penalties, the LCUP does not provide for a penalty waiver for tax positions supported by substantial authority or for taxpayers who act in good faith.[6]

The LCUP was previously subject to a facial challenge on the basis that it imposed an excessive fine in California Taxpayers Association v. California Franchise Tax Board.[7] In that case, the court found that the challenger failed to meet its "heavy burden" of proving "that the [LCUP] is, in all cases, excessive," the standard for a facial challenge.[8] At the same time, the court recognized that the LCUP could be excessive "as applied to a particular taxpayer."[9]

The court's decision in California Taxpayers Association was correct. There are some instances where the LCUP, as applied, is not excessive and, thus, not facially unconstitutional. For example, it does not appear to violate proportionality to apply the LCUP to an understatement attributable to fraud.

However, there are also fact patterns where the LCUP applies and its application could be viewed as disproportional. The following hypotheticals present fact patterns where the application of the LCUP might be determined to be disproportional:

- An understatement attributable to a reasonable, but incorrect, position that was disclosed on a California return.

- An understatement attributable to a federal change, when the taxpayer was not subject to a federal substantial understatement penalty.

- An understatement attributable to return position consistent with a decision of the Office of Tax Appeals that was not appealed or an unpublished court decision.

- An understatement attributable to reliance on a Franchise Tax Board publication that does not technically qualify as a "legal ruling."

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The U.S. Supreme Court's recent decision in Timbs v. Indiana, which held that the Eighth Amendment's ban on excessive fines applies to the states, may have state tax implications.[10] In particular, the holding in Timbs suggests that the Eighth Amendment may provide a defense against the assessment of strict liability state tax penalties, such as California's LCUP.[11]

The question presented in Timbs was whether the Eighth Amendment's protections against excessive fines apply to the states. In reaching its conclusion that the Eighth Amendment's ban on excessive fines applies to the states, the court observed that "[e]xorbitant tolls undermine other constitutional liberties," and that fines should be subject to particular scrutiny because of states' self-interest in imposing excessive fines (rather than raising revenue through other means).[12] Based on this rationale, the Court held that the Eighth Amendment's bar on excessive fines applies to the states.[13]

The Supreme Court has held that a punitive fine "violates the excessive fines clause if it is grossly disproportional to the gravity of a defendant's offense."[14] As a practical matter, this fact-specific standard can be difficult to apply.[15] However, at a bare minimum, the excessive fines clause would appear to mandate a constitutional escape valve for fines imposed on a strict liability basis. Without such an escape valve, there would be nothing to ensure any relationship between the gravity of an offense and the amount of the fine.

Takeaway

As a practical matter, the Franchise Tax Board might be hesitant (or unable) to provide full relief from the LCUP on Eighth Amendment grounds until at least one taxpayer successfully challenges the imposition of the LCUP as an excessive fine at the Court of Appeals.[16] However, under the right facts, a taxpayer facing the imposition of the LCUP should consider preserving this defense in its protest letter. Taxpayers facing the imposition of the LCUP should also consider raising the excessive fine defense as a basis for a settlement proposal to the board based on the hazards of litigation.[17]

2. California May Expand Its False Claims Act to Include Tax Claims

California legislators are considering a bill, AB 1270, which would amend the California False Claims Act, or CFCA,[18] to include claims under the California Revenue and Taxation Code. In general, false claims act statutes are intended to help the government uncover and prosecute fraudulent behavior. Congress enacted the first false claims statute in 1863 in response to illegal price-fixing and defective weaponry and supplies sold to the Union Army during the Civil War.

The current federal False Claims Act, or FCA,[19] prohibits any person from knowing presenting a false or fraudulent claim for payment or approval to the federal government. Any person found liable for violating the FCA is liable for civil penalties and treble damages. The FCA does not cover claims under the Internal Revenue Code.

The CFCA is modeled on the FCA. It encourages employees, contractors or agents to disclose false or fraudulent claims that their employers or others have made to the government, and protects the disclosing parties from retaliation. The CFCA authorizes the attorney general, the prosecuting authority of a political subdivision, or qui tam plaintiff to bring a civil action in the name of the state or political subdivision. Like its federal counterpart, the CFCA also allows for treble damages and civil penalties.

The CFCA is already broadly utilized in California. For example, as recently as last year, an oil and gas company agreed to pay over $100 million to settle a CFCA lawsuit alleging it overcharged California localities for natural gas.

Similar to its federal counterpart, the current CFCA excludes tax claims. AB 1270 would change that. The bill would amend the current CFCA to expressly authorize tax-related false claims actions under the Revenue and Taxation Code if (1) the damages pled in the action exceed $200,000, and (2) the amount of reported taxable income, net income, or sales equals $500,000 or more.

It would also authorize the attorney general, but not a qui tam plaintiff, to obtain otherwise confidential information related to taxes, fees, or other obligations under the Revenue and Taxation Code. The bill would also expand the definition of "prosecuting authority" to include "counsel retained by a political subdivision to act on its behalf."

The federal government and most states exclude tax claims from their False Claims Act statutes because the application of tax laws is wrought with uncertainty and complexity that could lead to numerous lawsuits that could overburden the judicial system.

One need only look to the experience of business taxpayers in New York and Illinois to understand the potential pitfalls of expanding false claims acts to include tax claims. Last year, a telecom company settled a New York False Claims Act action involving an alleged undercollection of sales tax for over $300 million. The whistleblower in that case **received over $60 million**, creating a significant incentive for whistleblowers to make further tax claims. Cottage industries have developed in New York and Illinois, where plaintiff-side law firms specialize in finding industries or products where the sales tax collection obligations are ambiguous and then looking for whistleblowers.

A cottage industry has already developed in California for law firms bringing nontax CFCA matters and it is likely the same firms will expand to include tax claims if the bill passes.

Takeaway

If the bill passes, California taxpayers will need to consider potential CFCA exposure on any tax return position or claim. Furthermore, the statute of limitations for a CFCA claim is 10 years from the date of the violation. Consequently, taxpayers will need to beware of potential CFCA exposure on tax positions beyond the normal statutes of limitation applicable to California tax matters (typically three or four years). Taxpayers would also need to consider past positions if the bill passes, to evaluate potential tax underpayment exposure.

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[1] Cal. Rev. & Tax. Code § 19138.

[2] Cal. Rev. & Tax. Code § 19138(f)(1).

[3] Cal. Rev. & Tax. Code § 19138(f)(2)

[4] Cal. Rev. & Tax. Code § 19138(f)(3).

[5] Cal. Rev. & Tax. Code § 19138(g).

[6] See, e.g. IRC § 6662(d)(2)(B)(i) and (ii); IRC § 6664(c)(1); Treas. Reg. § 1.6664-1(b)(2); Treas. Reg. § 1.6664-4.

[7] Cal. Taxpayers Ass'n v. Franchise Tax Bd. , No. 34-2009-80000168, 2009 WL 8413818 (Cal. Sup. Ct. Sacramento May 20,2009), aff'd 190 Cal. App. 4th 1139 (Cal. Ct. App. 3d Dist. 2010).

[8] Id.

[9] Id.

[10] 139 S.Ct. 682 (2019).

[11] Cal. Rev. & Tax. Code § 19138. While this article focuses on the LCUP, a similar defense could be raised for other strict liability state tax penalties, such as the amnesty penalties imposed by Pennsylvania and New Jersey.

[12] Id. at 6–7.

[13] Id. at 2.

[14] United States v. Bajakajian, 524 U.S. 321, 334 (1998).

[15] See David Pimental, Forfeitures & The Eighth Amendment: A Practical Approach to the Excessive Fines Clause as a Check on Government Seizures, 11 Harv. L. & Pol. Rev. 541, 543–44 (2017); Beth A. Colgan, Reviving the Excessive Fines Clause, 102 Cal. L. Rev. 277, 295 n.92 (2014).

[16] See Cal. Const. Art. III, § 3.5(a).

[17] See Cal. Rev. & Tax. Code § 19442; FTB Notice 2007-2.

[18] Cal. Govt. Code §§ 12650-12656.

[19] 31 U.S.C. §§ 3729-3733.