ReedSmith

California Court Tentatively Holds 50% Tax Shelter Promotion Penalty Cannot Apply Retroactively

Author: Marty Dakessian, Partner, Los Angeles
Author: Kyle O. Sollie, Partner, Philadelphia
Author: Brian W. Toman, Partner, San Francisco
Author: Mike Shaikh, Associate, Los Angeles

Publication Date: November 07, 2011

A San Francisco Superior Court has released a tentative statement of decision, holding that the Franchise Tax Board (FTB) could not retroactively apply an increased penalty rate for tax shelter promotion activities.[1] In *Quellos Financial Advisors, LLC v. Franchise Tax Board*,[2] the court held that the statute authorizing the increased penalty rate did not provide for, and California case law did not allow, the FTB to apply the increased rate retroactively.

The statute at issue in *Quellos* was section 19177.[3] For the taxable years at issue in *Quellos*, section 19177 conformed to Internal Revenue Code (IRC) section 6700, which provided for a maximum penalty of $1,000 for promoting abusive tax shelters. On October 2, 2003 (and after the tax years at issue in *Quellos*), California amended section 19177[4] to replace the maximum penalty of $1,000 with a new maximum penalty of 50 percent of the gross income derived from the penalized activity. For all other purposes, section 19177 continued to conform to IRC section 6700.[5]

The bill that enacted the increased maximum penalty stated, "this act shall apply with respect to any penalty assessed on or after January 1, 2004, on any return for which the statute of limitations on assessment has not expired. All other provisions of this act shall apply on and after January 1, 2004."[6] It is important to note that the bill enacted or revised several assessable penalties in addition to the penalty on tax promoters.

In *Quellos*, the FTB argued that the increased maximum penalty for tax shelter promotion activities should apply retroactively-i.e., to pre-2004 conduct-because the first sentence of the effective-date provision quoted above allows the FTB to assess the penalty at the higher rate as long as the assessment occurs on or after January 1, 2004, regardless of when the penalized activities took place. However, the Superior Court stated that the bill language allowing retroactive application of penalties only applied to penalties assessed on a return. Under federal case law, which California follows, the tax shelter promotion penalty is not a penalty assessed on a return.

The Superior Court cited numerous California cases that stand for the proposition that a statute cannot be applied retroactively, and that a contrary conclusion cannot be inferred from vague phrases and broad general language. Rather, the court said absent an "express retroactivity provision" in the statute itself, "[a] statute will *not* be applied retroactively unless it is *very clear* from the extrinsic sources that the Legislature . . . must have intended a retroactive application."[7]

Because the effective date language in the bill cited by the FTB did not specifically apply to the increased maximum penalty for tax shelter promotion activity, the court determined that the changes to the tax shelter promotion penalty could not apply retroactively unless some other provision of the 2003 act amending section 19177 provided for retroactivity.[8] No other provision in the statute could be interpreted as allowing the changes to the tax shelter promotion penalty to apply retroactively.

Additionally, the court rejected the FTB's argument that the legislative history of the 2003 amendment to section 19177 indicated that the penalty should apply retroactively. In fact, the court found that the legislative history indicated that the penalty's purpose was to stop promoters from *continuing* their shelter activities, which can be accomplished with a prospective-only penalty.

Accordingly, the court concluded that the penalty should apply on a prospective-only basis. Thus, the applicable rate for the promoter penalty for activities in taxable years 2000 and 2001 was $1,000.[9] Interestingly, the court found further support for this conclusion in the revenue estimates provided in the legislative history, which the court states only address "estimates of the overall revenue expected to be raised by the bill"-not the individual components-and as such "[d]o nothing to indicate that the promoter penalty was intended to be retroactive."[10]

The plaintiffs also argued that retroactive application of the 50 percent of gross receipts penalty would violate the Due Process clauses of both the United States and California Constitutions. However, the court did not reach this issue because the statutory and

constitutional issues were bifurcated and, as the court decided the case on statutory grounds, it did not have to reach the constitutional issues.

Thus far, the Superior Court has issued a tentative statement of decision, which is not final or binding.[11] As noted above, each party may only propose revisions to the decision based on drafting, factual, or other similar matters, as opposed to objections on substantive grounds. Additionally, once a final statement of decision is issued, the FTB will have the right to appeal the decision before a California Court of Appeal. We understand the FTB intends to appeal the trial court decision.

It is noted that if the decision of the trial court is reversed on appeal, the case should be remanded to the trial court to decide the constitutional issues. Lastly, taxpayers should keep in mind that the FTB has the burden to prove the applicability of any penalty proposed under section 19177.[12] This is an important issue in the case, but one that the court did not need to address because of its decision on the statutory grounds discussed above.

If you have questions about the tentative statement of decision in *Quellos*, or the workings of California's penalties on tax shelter promotion activities, 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.

---

1. In the tentative statement of decision, the court stated that any proposed revisions shall not reargue the substance of the matters decided, but rather shall be limited to drafting, factual, or similar matters. Thus, as a practical matter, it seems the substance of the tentative statement of decision will not be revised.
2. Case No. CGC-09-487540. Tentative Statement of Decision filed October 31, 2011 ("TSOD").
3. Unless otherwise noted, all section references are to the California Revenue and Taxation Code.
4. Stats. 2003, c. 654 (AB 1601), § 9; Stats. 2003 c. 656 (SB 614) § 9.
5. In October 2004, Congress amended IRC section 6700 to increase the penalty to 50 percent of the gross income derived from tax shelter promotion activities. In 2005, California once again conformed section 19177 in full to IRC section 6700.
6. Stats. 2003, c. 654 (AB 1601), § 15(a); Stats. 2003 c. 656 (SB 614) § 15(a).
7. TSOD, p. 6 citing Myers v. Phillip Morris Co. (2002) 28 Cal. 4th 828, 841 (emphasis supplied by trial court).
8. "There is one statement in the legislative history specifically relating to when and how the fifty percent penalty would become effective: 'This provision applies to penalties assessed after January 1, 2004.' Defendant's RJN [Request for Judicial Notice], Ex. C., at 13. This statement, however, is silent with respect to whether it applies to conduct that took place prior to that date." TSOD, p. 13:21-25.
9. This conclusion should also apply to taxable years 2002 and 2003, taxable years not before the court, but taxable years prior to the 2003 statutory amendment.
10. TSOD, p. 12.
11. California Rules of Court 3.1590.