

Nikki Dobay: Hello and welcome to GeTtin' SALTy, a state and local tax policy podcast hosted by Greenberg Traurig. My name is Nikki Dobay, shareholder in the Sacramento, California and Portland, Oregon offices.

I am very pleased today to have two guests with me that are going to help me unpack a case that is kind of hot off the presses, and it is the California 2024 budget litigation that has been going on in California for a little over [00:00:30] a year now.

Joining me is my colleague shareholder Shail Shah from our San Francisco office, and I'm also very pleased to have joining us for this conversation, Joseph Bishop-Henchman, the Executive Vice President of National Taxpayers Foundation, who has been very involved with this case that NTU has put forward and Shail and I have been working on. So thank you both so much [00:01:00] for being here and talking about this.

All right, so we had some big news coming out of Sacramento this week. So Shail, why don't you catch us up on what happened in this case, where we're at, a little background?

Shail Shah: Thanks, Nikki. I know we've discussed this case before on the podcast, and I'll give the listeners just a quick background.

Senate Bill 167, which passed last year, enacted a statute called Section 25128.9. [00:01:30] What that statute did was it effectively codified a legal ruling by the Franchise Tax Board's 2006 Statute 1 that says that for sales factor purposes, gross receipts really means net income. What that statute says is that when you have gross receipts, that those gross receipts, and any sort of receipts that are not directly tied to the generation of income, so, for example, deductions, anything that is not directly tied to the generation [00:02:00] of income, is excluded from the sales factor. And so you effectively have a parity between what's included in that income and what's included in gross receipts.

That particular statute is contrary to a litany of cases that came out of the Office of Tax Appeal, going all the way back to the appeal of Robert Haft. You had the appeal of Minnesota Beet Sugar, and you had the appeal of Microsoft, all those cases which rejected the FTB's interpretation and [00:02:30] legal ruling 2006 Statute 1 and our rule in a matter that's quite the opposite of what's in the statute.

So that's sort of the lay of the land of where we are now.

Nikki Dobay: I guess what was the piece of this that was so, I'm going to just go and say it out loud, change in law, but how was that going to be applied to taxpayers?

Shail Shah: Yeah, this is the most troublesome part of the statute. I think we all know that the legislature has the ability to change the law [00:03:00] on a prospective

basis, and so that complies with the due process clause. But with this particular statute, there is an unlimited retroactivity pay period. So, as I just mentioned, cases have consistently interpreted the statute in California that mean gross means gross.

And this particular statute, as you just mentioned, Nikki, 25128.9 is a change in law because inconsistent with prior interpretations. But the legislature stated [00:03:30] that it is just a mere clarification, and because it's a mere clarification that it has an unlimited retroactivity period, which is, like I said, a lot different than the way most taxpayers had interpreted the existing law.

Nikki Dobay: Joe, now let's shift over to NTU, because this is a question that has come up a few times from the other side after a suit was filed. Why does NTU care about this retroactive law change?

Joseph Bishop-H...: [00:04:00] Yeah. We obviously do care. The case is National Taxpayers Union versus Franchise Tax Board. So you see right there in the caption how much we care about it. I think this enactment by California violates the rule of if you're going to do this dumb stupid thing, don't do it in this dumb stupid way.

Nikki Dobay: It's a very technical rule that you've decided.

Joseph Bishop-H...: The underlying policy is a pretty bad policy for the reason Shail, [00:04:30] just went into, and then they went and enacted it in this... I mean, it is a statute. It's not one I've ever seen before in decades of working with statutes and enactments at the state level, where it's essentially directing an agency to adopt a particular interpretation of a statute. So it's not amending a statute, which is normally how you would accomplish doing that, and then it's applying it retroactively [00:05:00] with really no end date. So it's ably back 50 years or more.

I personally have a big problem with retroactive tax increases. I think they're absolutely unfair to unsettle expectations and change the rules of the game in that way. And I happen to think that the Constitution's due process clause has a problem with retroactive tax increases. Certainly ones that reach back this far.

[00:05:30] And even in the argument yesterday, the other side... forget our lawyers... the other side; the government's lawyers, the Franchise Tax Board, they were saying, "Oh yeah, this is a broad statute." And the judge was saying, "Who knows what the agency's going to do with it." This is laws we're talking about. They're supposed to be providing certainty to the taxpayer, not these giant question marks that will take a decade of administrative process to sort out.

So that's why. This isn't right. This isn't how it should be done. So we were [00:06:00] enthusiastic to challenge this.

Nikki Dobay: All right, so Joe gave some major spoiler alerts. So first of all, the big one. NTU as well as Caltech, both filed suits against this law last year. Those suits have been going through some procedural processes throughout the last year. And then from the date of the release, it'll be about 10 days prior to the release of this podcast, there was a decision and [00:06:30] oral arguments in this case.

Shail, why don't you fill us in on what the court said? The way it works in California is you get a tentative ruling, and then you get to go in and try to change the judge's mind. What did that tentative say? We can all just have a very robust conversation, so Joe, jump in at any time. But let's talk about the ruling and the argument and what came out of this.

Shail Shah: As Nikki [00:07:00] and I, and Joe as well, know very well, we were supposed to receive the tentative a couple of weeks ago, and then the court kicked the tentative a week. We were supposed to get it last week. They kicked it another week. And then finally this Tuesday we received the tentative.

It was unfortunate that the tentative went against NTU, but it wasn't on the substantive grounds we just discussed. It was on procedural grounds. [00:07:30] One of the arguments that the FTB has made all along is that Section 32 of the California Constitution bars NTU from challenging the statute. And what Section 32 is, is it is a provision in the California Constitution that prevents taxpayers from stopping or enjoining tax agencies from collecting taxes.

[00:08:00] What the court said was, "Hey look, we think your challenge to 25128.9 is barred under Section 32." And because Section 32 applies, we did not go through what's called exhaustion of administrative remedies. We did not go through the sort of pay first litigate later process. And that's what the tentative said.

Nikki, you're right, it is somewhat unique in California where you receive a tentative... we received it on Tuesday... and [00:08:30] you have very little time between the time you receive the tentative to the time you actually have to go in and make oral arguments to try to convince the judge to change his or her mind. We received the tentative at 2:00 PM on Tuesday and our oral arguments were set for 9:00 AM on Wednesday.

Nikki Dobay: Yeah. What was very surprising here was California has a long-standing history of allowing associations to bring [00:09:00] litigation on tax issues in California. And the FTB in several of the much more recent cases, it doesn't seem like some of the older cases, Section 32, or the applicable statutory provisions at the local level were raised, but the FTB has been much stronger on their pushing this Section 32 as a bar or associational standing. From my perspective, [00:09:30] as somebody that's been involved in associational standing cases, the court's ruling was very surprising.

Joe, I don't know if you want to jump in, and then we'll get back to Section 32. But associational standing isn't new or strange or weird?

Joseph Bishop-H...:

Right. And I know this podcast is GeTtin' SALTy, not getting First Amendment-y. Associations can sue standing in the shoes of their donors or their members in a way that [00:10:00] other people can't in order to achieve things. Throughout this litigation, the government lawyers, the California Franchise Tax Board lawyers have continuously demanded our member list in discovery requests and in interrogatories and depositions and motions for the court. They keep saying we need NTU's list of donors, which we will not provide, and we have a First Amendment right not to provide it.

There's numerous Supreme Court [00:10:30] cases, including some recent, going back to the civil rights era when the Alabama government was demanding the member lists of civil rights groups for terrible reasons, all the way up to today where you have it both ways. You have Democratic governments demanding lists of right-wing groups; you have Republican governments demanding lists of left-wing groups. And our view, and I think the view of most First Amendment scholars and people familiar to this area, is you have a First Amendment right not to disclose that.

And ultimately, [00:11:00] unfortunately, that's what the judge's decision came down to, because we will not name a member who has exhausted their administrative remedies, we therefore don't have standing. It eviscerates associational standing, violates the First Amendment, in addition to the due process clause and a whole bunch of other stuff that we've been talking about.

We're obviously very disappointed. The oral argument, I think the judge was tracking the discussion, but some of the responses [00:11:30] were very disappointing. I think it was Shail who raised a directly on-point contrary case to what the judge was asserting, and the judge replied, "Oh, that's our a tax case." Well, this is more than just tax. The law of retroactivity, the law of associational standing. This is more than just tax. This is just common constitutional law, common black letter law that should be applied across the board.

I was reminded of a comment that Judge Easterbrook wrote at some point [00:12:00] saying that there's no law of the horse. We have lots of cases about horses, but that doesn't equate to a horse law. The point he was trying to make is resistance. I think it was about tech policy and tech law that we shouldn't be creating tech-specific cases.

And as much as I work for National Taxpayers Union where we care a lot about taxpayers, I'm against tax exceptionalism. This idea that the government should have the scales tilted towards it, or tilted against it, because [00:12:30] tax is involved and tax is somehow special and needs to play by different rules, you still have to follow the First Amendment. And I certainly hope that's an argument we make on appeal because it's wrong, wrong, wrong, wrong, wrong.

Nikki Dobay: Right. The court here to my mind, to use a very technical term, really kind of mushed together the associational standing and the Section 32 issue. And for purposes of briefing, I think that he [00:13:00] was kind of led down that path by the FTB, but we tried to always keep them very, very separate.

And from our perspective, there's a test that provides the associational standing requirements. There's three of them. They come from this Hunt v. Washington, Apple Growers. It's an apple growers case. It's a fascinating case. People love the apple growers. But we were clearly able to meet that test, and NTU has members that are impacted. This is within the purview of your mission, which is to protect [00:13:30] taxpayer rights. And this is a facial constitutional challenge which did not require any member to participate. We had evidence of that through declarations by the association. We were never going to disclose a member, and we felt very strongly that we met all those prongs.

Shail, I'd like you to... because you did a very nice job of arguing this. What the court really did, he wasn't focused on the case law in [00:14:00] California that really talks about when Section 32 applies and when it doesn't. And from our perspective, this is not a case where Section 32 is even part of the analysis.

Shail Shah: That's right, Nikki. For listeners outside of California, Section 32 was enacted during the Great Depression, and the purpose of Section 32 was to keep [00:14:30] the revenue flow and keep the coffers in California going during the Great Depression because what was happening was-

Joseph Bishop-H...: It's a mini tax injunction act for California.

Shail Shah: Exactly, exactly. Right. So for a lot of people who during the Great Depression were unable to pay taxes, their sort of recourse was as they were getting assessed is they would try to sue the FTB in court because they just quite frankly didn't have the money to pay the taxes.

That has always been the purpose of [00:15:00] Section 32. One of the distinctions we tried to implore on the judge was the difference between an as-applied constitutional challenge versus a facial constitutional challenge. We pointed through... A lot of the case law that the FTB raised around Section 32 were bar a taxpayer from suing the government over a particular statute. All of those cases dealt [00:15:30] with an as-applied.

So these were sort of prepayment. You had a taxpayer that was potentially going through an audit, hit the pause button during the audit, and said, "You know what? I'm going to go ahead and sue the FTB or the CDTFA," or whatever agency at that time in court. And that is clearly prohibited under Section 32.

But the difference here with NTU's case is that we were not challenging the as-applied of 25128.9, rather, it was a facial constitutional challenge. [00:16:00] In other words, our argument has always been, if you look at the words of the

statute, the retroactivity language in that statute violates the US and California Constitution. It's very clear.

I think one of the challenges we were having, and part of this may have been intentional by the FTB to sort of mush a lot of these issues together, is the judge kept saying, "Well, why don't we let this all play out, and why don't we have a taxpayer go through the administrative process?" [00:16:30] The problem with that is; that is an as-applied analysis, and that has never been the issue here. Clearly, if a taxpayer was going through an audit and received an assessment, and the assessment was, "Hey, you have to exclude these gross receipts from your sales factor," that particular taxpayer cannot then hit pause on the administrative process, and then go to [00:17:00] Superior Court and ask for an injunction. That was not what we're doing.

I think it was unfortunate that despite the judge saying that he understood the difference between facial challenges and as-applied challenges, I think he unfortunately was still mixing the two concepts together.

Joseph Bishop-H...: The judge may think it's better administrative-wise to pursue an as-applied challenge. Let the cases handle it. Let the [00:17:30] Franchise Tax Board come up with their interpretation. Although since this has been something they've been fighting for decades, I would be surprised if they depart from that.

When people sue facial versus as-applied, and as a lawyer, I think we've been all in conversations with clients of, oh, do we do facial or do we do as applied? But, I don't know, the judge somehow converted that which is better into the idea that the law compels [00:18:00] as-applied challenges and does not allow for facial challenges, which is just very surprising. Facial challenges, there's a bar you have to hit, but it's not like they are unheard of. They're certainly out there. And this idea that either we as NTU need to exhaust some administrative process, which is weird because we're not a pay California franchise tax as an organization, there just is no process.

[00:18:30] I was half joking of going up to the government's lawyer and saying, "Can you just write something saying whatever process NTU has over this assessment is completed, and we've exhausted your administrative remedies." So either that on the one hand or this idea that in order to have standing we need to name names.

Nikki Dobay: And they need to vet all of those names.

Joseph Bishop-H...: Right. There's just a lot of problems.

Nikki Dobay: [00:19:00] As I've also been reflecting on the argument in particular where I think the judge maybe got a little confused was the question about whether or not this was a change of law. And he didn't think that he could look at the words of the before and after statute and determine if that was a change of law. The

approach we took in our briefing was to really lay out [00:19:30] this prior to Senate Bill 167, the law was gross receipts. That was what you used for purposes of apportionment. There were some exceptions based on cases that had been decided that the legislature made a policy decision to incorporate prospectively into those definitions.

But then, as Joe said, the strange thing about 167 was it didn't just go back and amend those [00:20:00] provisions to maybe restrict them more. It just created a whole new provision that said something completely different. And I think as tax people we're used to looking at those types of statutes and saying, this means this and this means X and this means Y, and they're different.

And to me, somehow he had been convinced that he needed facts in order to determine whether or not there was a change in law. [00:20:30] That to me, as I've been reflecting on this, seems to be where his confusion was about this is why the agency needs to take a stab at this first. And I think the three of us would all disagree with that.

Joseph Bishop-H...: And to the judge's credit, this is an oddly written statute. It's like none I've ever seen before. This isn't quite the case, but it's almost as if they took some whereas clauses and some wishes and [00:21:00] passed it as a law, and the government signed them into law.

Anybody that works with statutes is aware there's the operative part, the resolved clauses, and then there's the introductory the declaratory material, the whereas clauses, and the judge talked about it that way. But those clauses are not superfluous. They have been written into the code now.

Nikki Dobay: Right.

Joseph Bishop-H...: So it's not like it's just, oh, something the sponsor said on the floor before they passed [00:21:30] it, which you could weigh or not weigh as a judge. No, this is the words of the statute now. And yet he kept saying, almost as if who knows what this means, and he needs the agency to tell him, which is funny because they were right there, and he could have just asked them.

Nikki Dobay: Right. Yeah.

Shail Shah: I think again, going back to his mixing the concept of a facial challenge versus as-applied. By saying that well let the process play out, what he was effectively [00:22:00] saying is let's wait until the FTB applies the statute in an unconstitutional manner, and then I can sort of make an assessment whether the statute is unconstitutional. Again, we were trying to pull him back from that and trying to have him understand the distinction between a facial and as-applied, but, again, I think that concept kept getting melded together.

Nikki Dobay: I think before we wrap up, just to get some of the big themes out there. There will be next [00:22:30] steps, and we'll talk about those in a sec. It just can't be that Section 32 is a complete bar, which is effectively what the FTB has made it, because there are many cases where there have been declaratory actions that the courts have ruled on. And there are many cases where there have been associations that have brought those challenges.

The court's been very clear. And I know, Shail, you did everything [00:23:00] you could during that argument to get these points across, that a facial challenge can be heard in this context. But we were not able to sway him on that point. So we got our final ruling. The FTB's motion for summary judgment was unfortunately granted, and ours denied. And I think we're now going onward and upward, Joe?

Joseph Bishop-H...: Yeah. We have this parallel case brought by California [00:23:30] Taxpayers Association where they did name a name with their consent. It seems to be they're okay with it, but even there they were ruled against. So it's possible we could be in a situation where I was like, well, if only I named the name, we would be in a better place. But actually we wouldn't if the judge said that that wasn't good enough either.

Yeah, certainly this needs to be corrected. We can't just wait around for the FTB to [00:24:00] apply this what they themselves acknowledge is a very broad, hard statute, and what the judge says is a hard to understand statute. We just can't wait five or 10 years for every company in California to figure it out eventually.

I'm very grateful to the GT team for representing us in this. I think it'll be for the long haul. Especially on a case like this where we get this tentative decision, and then we all have to rush [00:24:30] to Sacramento. I think, Shail, you're in the Bay Area, so you're a little local, but everybody else kind of rushes in like it's a mad, bad world in order to do this.

I think we did a good job. We preserved all the key arguments there. It's just very frustrating when you say, "Judge, here's a directly on point contrary thing from the Court of Appeals, you should be careful here," and doesn't listen to you.

Nikki Dobay: Shail, final thoughts as the [00:25:00] voice that tried to be of reason in this argument.

Shail Shah: I think one of our colleagues mentioned that maybe the quick inaction at the trial court level will serve us well at the Appellate Court. We'll keep making the same arguments. I know we're in the right, and hopefully we'll get a favorable decision out of the Appeal Court, and the battle continues.

Nikki Dobay: [00:25:30] All right. Well, thank you both. We had hoped this would be a very joyful conversation, where we won, and it was unconstitutional. We knew it wouldn't be over then, but definitely we were a little surprised earlier this week.

But before I let you go, I got to do a surprise non-tax question. I came up with a good one. Well, actually I asked the internet, and it came up with a good one.

If you could time travel to any historical event, what would [00:26:00] it be and why? This one for me is really hard. So if anybody has one off the bat. I will say I wouldn't want to go into the future I think because kind of afraid of the future sometimes right now, just where everything's at. And I won't say anything more on that. But going back in history, that'd be hard. There's particular events. Anybody got one on the tip of their tongue?

Joseph Bishop-H...: [00:26:30] I saw they've done the new Back to the Future musical where they add a few scenes obviously, because you need to pad it out a little bit. Doc Brown comes back, and he's like, "I went to 2020, and there was no traffic." Just on your point of being worried about the future.

I'm always one of those people that says I wouldn't want to live in any time other than the time we're living in. I think people look on the past with rose-colored glasses and everything. [00:27:00] There's some historical events that it'd be pretty neat to watch, I think. I just read a book on 1960. There was a debate between Kennedy and Johnson at the Democratic Convention that was not recorded as far as I know. So it got lost to history. I think it'd be pretty neat to watch that when they were running against each other. This was before they ended up forming a ticket. And knowing everything that happened afterwards, that'd be pretty neat to see, I think.

Nikki Dobay: Yeah. If I was going to go back to some event, I think it would be some [00:27:30] sort of musical event. I don't know if it's Farm Aid or one of those crazy concerts in the 80s. I feel like it would be something in the 80s, because I lived in the 80s, but I was young. And now kind of looking back, and I'm not looking back through rose-colored glasses, but it's like there's some pretty cool stuff that happened.

Joseph Bishop-H...: [inaudible 00:27:52].

Nikki Dobay: Yeah. Yeah. How about you, Shail?

Shail Shah: I recently listened to a podcast about the Great Gatsby. And I had read that [00:28:00] back in high school. Apparently, it's made a resurgence. They were talking about the roaring 20s. All they talked about was basically how people would drink cocktails and threw house parties. And I thought, "You know what? I'd like to go back to the 20s and drink some cocktails and go to a house party."

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Joseph Bishop-H...: It is amusing to me that the Great Gatsby has become this byword for a fun costume party rather than the soulless emptiness [00:28:30] of existence, which is the actual theme of the novel.

Nikki Dobay: Well, I guess if you're just drinking and having house parties, same side of the... I don't know what that saying is. All right, well, Shail, you're going back to the 20s. Joe's going to debates, and I'm going to some concert in the 80s. So I think we're well-rounded.

Well, thank you both for joining me. And for being at the argument, Shail, great job arguing. And Joe, we're just really grateful to also be [00:29:00] working with NTU on this. I think both the standing and the substantive issues are extremely important.

And thank you to the listeners for joining us today. Information for Shail and Joe will be in the show notes. And if you have any comments or questions, please leave those in the show notes as well. And I will be back in a few weeks on the next GeTtin' SALTy.