PUBLICATION

Spotlight on SALT: California's Gillette Decision Raises a Host of Potentially Significant Taxpayer Opportunities Nationally

August 7, 2012

In 1974, California enacted the Multistate Tax Compact (Compact) and became a member of the Multistate Tax Commission (MTC). The Compact's business and nonbusiness income and income allocation and apportionment provisions were modeled after the Uniform Division of Income for Tax Purposes Act (UDITPA) that was adopted in 1957 by the Uniform Law Commission. In addition to division of income, the Compact covers a spectrum including interstate joint tax audits, elements of sales and use tax laws, establishment of the MTC and other matters. The Compact uses an equally-weighted three-factor formula to apportion business income of multistate businesses based on property, payroll and sales factors. The Compact also sources gross receipts from services to the sales factor based on the state where the greatest proportion of the costs of performing those services is incurred.

Background

A number of MTC member states, like California, retained their corporate income tax statutes when they enacted the Compact. As a result, the Compact and the state's corporate income tax statute are separately codified within the state's laws. While various changes and amendments have been made to MTC member states' corporate income tax statutes over the years, an MTC state is bound with other member states to the Compact. For example, California in 1993 amended its Corporation Tax Law statute to double weight the sales factor. In 2011 California further tinkered with its Corporation Tax Law apportionment formula by providing corporate taxpayers with an election to apportion income using a single-factor formula based on sales. Apparently, California and certain other MTC member states were not concerned that their tax statutes contained one set of apportionment rules that were inconsistent with the apportionment rules contained in their separately codified Compact; that was, until a California Court of Appeals July 24, 2012 decision in *The Gillette Company v. Franchise Tax Board*.

A rarely considered Article III in the Compact, known as the "taxpayer option," together with the *Gillette* decision, are now sending shock waves through California, the MTC and other MTC member states. Under the Compact, the taxpayer option provides corporate taxpayers with the election to apportion and allocate income under state law "without reference to this compact, or may elect to apportion and allocate in accordance" with the Compact.

Within a matter of weeks before and after the *Gillette* decision was issued, California has left the MTC and repealed the Compact, the MTC's continued existence could be in doubt, and other MTC states may have similar conflicts between their tax statutes and Compact.

Gillette

In *Gillette,* the taxpayer filed refund claims of approximately $34 million. The refund claims were based on the taxpayer's position that the taxpayer option of Article III of the Compact, which was codified by California, allowed an election to apportion income to California using the Compact's equally weighted three-factor formula instead of California's double-weighted sales factor set forth in the Corporation Tax Law statute.

In deliberating the taxpayer's position, the California Court of Appeal brushed aside the Franchise Tax Board's argument that the taxpayer did not have standing to challenge because it was not a signatory to the agreement. Since the Compact was statutory law, the Court reasoned that a taxpayer asserting private rights under the Compact was no different than one asserting private rights under another state statute.

Next, the Court of Appeal held that because the Compact was both a statute and a binding agreement among sovereign signatory states, the double-weighted sales factor statute could not override the Compact's taxpayer option election. The Court also held that to override the Compact would violate federal and state constitutional prohibitions against impairment of contracts and California's "constitutional reenactment rule." Since the Compact was a valid, enforceable interstate compact, it could not be repealed unless the provisions for repealing the Compact that were laid out in it were followed.

What's Next?

Procedurally, there is some uncertainty as to what comes next. The California Court of Appeal reversed the trial court's dismissal of the taxpayer's refund suit and returned the case to the trial court on "remittitur." The trial court could now determine that the case raised only a question of law and there is nothing left to do but enter judgment in favor of the taxpayer. The Franchise Tax Board is likely to argue that there still are issues to be determined before the taxpayer has a right to a refund. As a procedural matter, there are still some judicial actions that need to occur before the case is final. The Franchise Tax Board is reported to be considering an appeal of the Court of Appeal's decision to the California Supreme Court.

Prior to the *Gillette* decision being announced, sensing the loss and state budget-busting consequences, California's legislature repealed the Compact from California law by passing S.B. 1015, which was signed into law by the Governor on June 27, 2012. The legislation also contains a provision noted as the "doctrine of elections" that provides that any election that affects the computation of tax must be made on an originally-filed return, not on an amended return. Ostensibly, this provision is intended to ward off other taxpayers now filing refund claims following *Gillette*. In dicta, the Court of Appeal indicated that such a repeal by the terms of the Compact "must be prospective in nature."

However, S.B. 1015 did not pass the California Legislature with the two-thirds vote required in California for revenue-raising bills. As a result, S.B. 1015 is subject to a California "Proposition 26" challenge that it was improperly enacted without two-thirds support of the Legislature. Thus, S.B. 1015 in its entirety, or that portion applying the "doctrine of elections," could be rendered null and void and will at a minimum be the subject of future challenges by taxpayers seeking refunds under the Compact's taxpayer option election validated by *Gillette*.

After the procedural questions noted above are resolved (likely near the end of September) and any further appeal occurs (the California Supreme Court's review is discretionary), these questions surrounding S.B. 1015 will move to the forefront.

National Importance

In terms of GDP, California's economy ranks eighth in the world. Any judicial decision like that of *Gillette* takes on national significance for many multistate businesses that have sales in California or a California taxable presence of the business or an affiliate. Further, the MTC is comprised of 19 members that have also enacted the Compact (after *Gillette* and S.B. 1015, California is no longer a member). For some of these states, similar refund opportunities may be presented. At a minimum, multistate businesses doing business in and apportioning income to an MTC member state should closely examine and determine if the Compact's

taxpayer option election could be applicable and, if so, whether such an election could reduce tax costs of the business.

For example, some MTC member states have changed their income apportionment formulas since enacting the Compact. These changes to income tax statutes in certain of those states have been many and significant, while their separately codified Compact's taxpayer option, equally weighted apportionment formula, and other apportionment provisions have not changed. Although an MTC member state may have preemptively addressed "*Gillette* situations" when enacting the Compact, there are still MTC member states with statutes that, like California, appear to provide the "taxpayer option" to multistate businesses apportioning income.

In recent years states have also tinkered with the sales factor and sourcing of gross receipts from services and sales of "other than tangible personal property," such as intangibles. The trend has been towards market sourcing of services and intangible receipts, and away from costs of performance sourcing. The Compact retains costs of performance sourcing and it remains to be seen whether any MTC state that has moved from costs of performance sourcing could be susceptible to a challenge that the Compact's "taxpayer option" election could allow for costs of performance sourcing despite the market sourcing otherwise required by a separate sales factor tax statute.

These and other issues will likely be addressed in the coming years. In the meantime, multistate businesses should carefully consider not only where and how they do business, but also whether they can benefit from the taxpayer option in California and other MTC states.

If you would like to discuss the *Gillette* case or other income tax issues confronting multistate businesses, please contact any attorney in the Firm's Tax Department.