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California - Taxpayers may elect to apportion income under the Multistate Tax Compact's equally weighted three-factor formula

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In brief

California was a signatory to the Multistate Tax Compact, which includes a provision that obligates member states to offer taxpayers the option of using: (1) an equally weighted sales, property, and payroll apportionment factor or (2) a state's alternative formula. California adopted a double-weighted sales factor in 1993. The taxpayers in this case asserted that the Compact, and its codification under California law, provided them an election to use an equally weighted apportionment factor for tax years at issue since 1993.

On July 24, 2012, in a 3-0 decision, a California Court of Appeal held that the Compact is a valid interstate compact binding California to provisions that include the equally weighted apportionment provision, which is codified under California law. Having entered into the Compact, California cannot, by subsequent legislation, unilaterally alter or amend its terms. California can avoid the application of the apportionment election only by repealing the statutory provision adopting the Compact, thereby withdrawing from the Compact. Since California has not withdrawn from the Compact by repealing the statute, the equally weighted

apportionment election is available to taxpayers. [[The Gillette Company et. al. v. Franchise Tax Board](#), Cal. Ct. of App., No. A130803, 7/24/12]

Note that California legislatively withdrew from the Compact on June 27, 2012 following the enactment of S.B. 1015. The manner in which S.B. 1015 was enacted raises many issues that make it likely to be challenged, including whether it passed with a sufficient amount of votes to satisfy requirements of Proposition 26, if applicable. Additionally, the bill included a declaration that an election affecting a tax computation must be made on an original return, thus calling into question whether taxpayers may claim the Compact election on amended returns.

For more detail regarding the application of California's apportionment formula, please read our June 15, 2012 publication, *California Apportionment Formula Uncertain* [available here](#).

In detail

In this summary of the *Gillette* decision, we review the Court's historical account of the Compact and California's apportionment methodologies; summarize the authoritative nature of interstate compacts generally; advance the FTB's various arguments and the Court's response to each; and provide observations on potential future actions and the implications to other California taxpayers.

History of the Multistate Tax Compact

The Uniform Division of Income for Tax Purposes Act (UDITPA) was promulgated in 1957 in order to advance apportionment uniformity across the states. UDITPA provides for an equally weighted apportionment formula. Following the US Supreme Court's 1959 decision in *Northwestern Cement*¹ (which generally allowed state taxation of an interstate entity so long as nexus, proper apportionment, and non-discrimination exists), proposed federal legislation attempted to impose uniform apportionment regimes on the states.

State tax administrators and other state leaders drafted the Compact to stave off federal encroachment of their taxing powers. The Compact is a binding, multistate agreement that obligates member states to offer multistate taxpayers the option of using: (1) the Compact's incorporation of the UDITPA equally weighted three-factor formula to apportion and allocate income for state income tax purposes, or (2) the state's own alternative apportionment formula. The election preserves the right of states to make such alternative formulas available to taxpayers while making uniformity available to taxpayers where and when desired. California adopted this election under California Revenue and Taxation Code (Section) § 38006.

Under the Compact, states are free to withdraw from the Compact at any time "by enacting a statute repealing the same." California also adopted this provision under Section 38006.

¹ *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

Gillette's procedural history

Prior to 1993, California used an equally weighted sales, property, and payroll formula for apportioning and allocating income. In 1993, California amended Section 25128 to provide that "[n]otwithstanding Section 38006, all business income shall be apportioned to this state" utilizing a double-weighted sales factor.

Taxpayers have claimed refunds utilizing Section 38006's equally weighted three-factor formula, asserting that amended Section 25128 did not override or repeal the apportionment election in Section 38006. The Franchise Tax Board (FTB) argued that the plain language of amended Section 25128 mandated the exclusive use of the double-weighted sales factor. The trial court agreed and found that Section 25128 clearly expressed an intention to take away the alternative under Section 38006. The taxpayers appealed to the First District Court of Appeal (Court).

Taxpayers have standing to challenge the application of Section 38006 and other elements of the Compact

Before the Court, the FTB asserted that the taxpayers lacked standing to challenge the Compact because the taxpayers were not parties to the agreement, only the signatory states are parties. The Court disagreed. Recognizing that "compacts are statutory law," the Court found that asserting private rights under an interstate compact is no different than asserting similar rights under other state statutes. Because the Compact, as codified under Section 38006, extends the apportionment election to taxpayers, the *Gillette* taxpayers "without question" have standing to enforce that right.

The Multistate Tax Compact is a valid interstate compact and California is bound by its terms

An interstate compact is a unique instrument existing both as an enforceable contract between member states and as statutes with legal standing within each state. The Court found that the Multistate Tax Compact qualified as a valid, enforceable interstate compact and, as such, could not be repealed but for following the repeal provisions detailed in the Compact.

The Court highlighted several unique attributes of interstate compacts, including that interstate compacts:

- Are legislatively enacted, binding and enforceable agreements between two or more states.
- "[m]ust be construed" as state law² and they "take[] precedence over the subsequent statutes of signatory states and, as such, a state may not unilaterally nullify, revoke, or amend one of its compacts if the compact does not so provide."

² Certain compacts that infringe on federal powers require congressional consent. Such concepts are not within the scope of the *Gillette* decision as the US Supreme Court decision in *U.S. Steel* concluded that the Multistate Tax Compact did not infringe on federal powers. See footnote 3.

- Are unique in that they "bind all future legislatures" to certain elements of the compact.
- Constitute not only law, but a contract that may not be amended, modified, or otherwise altered without the consent of all parties. In other words, a state may legislate within the parameters of the compact, but not in contravention of the compact.

"Classic indicia" of a compact include: (1) the establishment of a joint organization or body for regulatory purposes; (2) state enactments that require reciprocal action for their effectiveness; and (3) conditional consent by member states in which each state is not free to modify or repeal its participation unilaterally.

The Court found that the Compact satisfied the indicia of an interstate compact because: (1) the Multistate Tax Commission, created under the Compact, is an operational body charged with duties and powers in furtherance of the Compact's purposes; (2) the Compact includes reciprocal obligations that advance uniformity; and (3) the Compact provides for a state's withdrawal by enacting a statute repealing the Compact. Additionally, the Court recognized that the US Supreme Court upheld the Compact as an enforceable interstate compact in *U.S. Steel Corp. v. Multistate Tax Comm'n*.³

As an enforceable interstate compact, California can only repeal the Compact's apportionment election by completely withdrawing from the Compact through a repeal of the enabling statute

As noted above, recognizing the Compact as a valid interstate compact confers an enhanced significance to California's position as a member of the Compact. California must act within the parameters of the Compact to amend or repeal any element of it.

The primary argument advanced by the FTB was that the legislature's choice of "[n]otwithstanding Section 38006" language in amended Section 25128 effectively overrides and repeals the apportionment election provided in Section 38006.

The Court disagreed because such an interpretation ignores the dual nature of Section 38006, which is not only a state statute but also a binding, enforceable agreement under the Compact and "*having entered into it, California cannot, by subsequent legislation, unilaterally alter or amend its terms.*" The Compact "*is superior to subsequent statutory law of member states*" (emphasis in original).

³ 434 U.S. 452 (1978). In *U.S. Steel*, a group of taxpayers challenged the constitutionality of the Compact, asserting that it violated the compact clause of the US Constitution. The compact clause provides that "No state shall, without the consent of Congress, . . . enter into any agreement or compact with another state." In *U.S. Steel*, the US Supreme Court found that agreements are valid so long as they do not encroach upon or interfere with the just supremacy of the United States. Finding that the Compact does not enhance state power with respect to the federal government, the US Supreme Court found no constitutional violation. Among its reasons, the US Supreme Court provided that under the Compact states retain complete freedom to withdraw at any time.

Accordingly, "the Compact trumps section 25128" and it "requires states to offer this taxpayer option" of electing the equally weighted sales factor.

The FTB argued that the Compact allows a signatory state to repeal or withdraw from the Compact "in whole or in part." The Court found that the plain language of the Compact's withdrawal language allows only for a complete withdrawal from the Compact "by enacting a statute repealing the same" and that "any repealing legislation must be prospective in nature." Because California did not repeal Section 38006 and withdraw from the Compact, the equally weighted apportionment factor election in Section 38006 remained a viable option to taxpayers.

The FTB also claimed that the Compact violated the California Constitution's provision that the "power to tax may not be surrendered or suspended by grant or contract." The Court observed that California has not surrendered nor suspended its taxing powers under the Compact. For example, the state retains full control of its tax base and tax rate. It simply has obligated itself under the Compact to provide taxpayers with an apportionment election that can be rescinded by withdrawing from the Compact.

The FTB's construction violates constitutional prohibitions against impairment of contracts

Both the US and California constitutions prohibit California from passing any law "impairing the obligation of contracts." This constitutional prohibition extends to interstate compacts. As noted above, the Multistate Tax Compact was found by the Court to be a valid, enforceable interstate compact. Accordingly, the FTB's construction of Section 25128 overriding California's obligation under the Compact to afford taxpayers the option of using an equally weighted apportionment formula would be unconstitutional as violating the prohibition against impairing contracts.

The FTB's construction would violate California's Reenactment Rule

The California Constitution provides that a "statute may not be amended by reference to its title. A section of a statute may not be amended unless the section is re-enacted as amended" (the Reenactment Rule). The FTB's position is that the "[n]otwithstanding Section 38006" language of Section 25128 evidences an intent to repeal the provisions of Section 38006. However, under the Reenactment Rule, Section 38006 cannot be modified by reference. Because the legislature did not reenact the specific provisions of Section 38006, the language contained in Section 38006 remains.

Actions to think about

The FTB could appeal the Court's decision in one of two ways:

- Petition for rehearing in the Court of Appeal; or
- Petition for review by the California Supreme Court.

What is the impact of S.B. 1015 and a November ballot initiative?

As [previously reported](#), S.B. 1015, repealing all provisions in California law related to the Multistate Tax Compact, was enacted on June 27, 2012. Effective immediately, the repeal removes taxpayers' option of electing the equally weighted three-factor apportionment formula relied upon in *Gillette*.

S.B. 1015 also includes a provision regarding the "doctrine of elections" and states that any election that affects the computation of tax must be made on an originally, timely filed return. The legislation also states that this doctrine does not constitute a change in existing law; rather it is declaratory of existing law. Such provision, if enforceable, may mean that any refund claims made on an amended return and based upon an election to use an alternative apportionment formula are invalid. However, *Gillette* may draw such a conclusion into question as applied to the Compact because the opinion stressed that "any repealing legislation must be prospective in nature."

Note that S.B.1015 did not pass each House with a 2/3 vote (Assembly 50-27; Senate 24-15) as required by Proposition 26 for revenue raising bills. California's position is that the MTC apportionment election was not available to California taxpayers following the amendment of Section 25128 in 1993. As such, the provisions of S.B. 1015 do not create a tax increase for any taxpayer. However, the Court's decision in *Gillette* may render the state's position invalid and make S.B. 1015 susceptible to challenge under Proposition 26 as a revenue-raising bill. A successful Proposition 26 challenge striking down S.B. 1015 would make any legislative change to California's apportionment factor moot if taxpayers are able to make an equally weighted three-factor election under the MTC.

Currently, California allows a taxpayer to use a single sales factor apportionment, but only if the taxpayer elects to use market-based sourcing.

This November, California taxpayers will vote on the California Income Tax Calculations for Multistate Businesses Initiative, the "[California Clean Jobs Energy Act](#)," (#11-0080), which would require multistate businesses to calculate their California income tax liability utilizing a single sales factor apportionment formula. The initiative would repeal existing law giving multistate business an option to choose an apportionment formula that provides favorable tax treatment for businesses with property and payroll outside of California. If SB 1015 is void under Proposition 26, then taxpayers may still have an option to use the Compact election.

What next?

The impact of *Gillette* raises many questions for California taxpayers:

- For our extended 2011 tax return that will be filed shortly, what options does my company have with respect to decisions around apportionment and the Compact election? Do we choose single sales factor with market sourcing, or double weighted three-factor with cost of performance? How does the Compact election fit into all of this? What penalties do I need to consider?
- Is it too late to file refund claims taking the Compact election?

- Other than the sales factor weighting, what other impact does the Compact have on my tax return including the treatment of certain gross receipts, such as treasury receipts; *Joyce* versus *Finnigan*; and the applicability of special industry apportionment regulations?
- What should my company do about S.B. 1015 and the doctrine of elections?
- Whether or not the election is made on an original or amended return, what are the implications from an ASC 740 perspective of the *Gillette* decision, the passage of S.B. 1015, and the pending November business initiatives vote?

Let's talk

If you have questions about the *Gillette* decision, please contact one of the following individuals:

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