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California apportionment formula uncertain

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In brief

Legislation to repeal the single sales factor election and litigation addressing the Multistate Tax Compact has created a great deal of uncertainty regarding California's apportionment formula.

The storied history of California's apportionment formula

Single Sales Factor Election. In September 2008, then-Governor Arnold Schwarzenegger signed into law the 2008 California budget that contained several significant changes to the California Revenue & Taxation Code. While the 2008 California budget closed an existing \$16 billion deficit, by December 2008 the budget deficit was estimated at more than \$40 billion. By January 2009, State Controller John Chiang warned that the state was about to run out of cash if immediate action was not taken by the legislature.

In the early hours of February 19, 2009, after one of the longest and most contentious extraordinary sessions, the legislature approved a revised budget. The budget bills enacted on February 20, 2009, contained revenue raisers and incentives designed to stimulate California's economy, including the introduction of single sales factor apportionment and the repeal of the cost of performance rule for sourcing of service income.



The budget bills added Cal. Rev. & Tax Code Sec. 25128.5, which provides that any apportioning trade or business (other than businesses that derive more than 50% of their gross receipts from agriculture, extractive business, savings and loans, or bank and financial activities) may make an annual irrevocable election on an original timely filed return to use a single sales factor for apportionment. At the time, the generally applicable apportionment formula was property, payroll, and double-weighted sales.

Existing cost of performance provisions with respect to sales of other than tangible personal property were repealed and were replaced with market-based sourcing provisions effective for taxable years beginning on or after January 1, 2011.

In October 2010 Gov. Schwarzenegger signed yet another budget agreement with the legislature containing significant tax legislation addressing apportionment. Effective January 1, 2011, the October 2010 agreement revived the cost of performance method for taxpayers that apportion with either the generally applicable three-factor, double-weighted sales formula or the equally-weighted formula of property, payroll, and sales applicable to certain taxpayers. Market-based sourcing applied only to taxpayers electing the single sales factor apportionment.

Ballot Initiative Fails. While the Governor and the legislature worked out deals to close the state's budget deficit, Proposition 24, the "Repeal Corporate Tax Loopholes Act" was qualified for the November 2, 2010 ballot. Proposition 24 was an effort to stop corporate tax breaks approved by Gov. Schwarzenegger, including the single sales factor election enacted in February 2009. With 58% of voters in opposition to the initiative, Proposition 24 failed to pass, clearing the way for elective single sales factor apportionment for taxable years beginning on or after January 1, 2011. If the proposition had passed, the single sales factor apportionment election and market-based sourcing would have been repealed.

Is there a mandatory single sales factor in California's future?

Proposed Legislation and a Ballot Initiative. On January 10, 2012, California lawmakers introduced legislation that would require businesses to apportion their income using a single sales factor for taxable years beginning on or after January 1, 2012, unless the business derives more than 50% of its gross receipts from agriculture, extractive business, savings and loans, or bank and financial activities. The bill appeared to be stalled after its introduction, but gained momentum in May 2012 and is currently awaiting a third reading in the Assembly.

In the meantime, signatures to qualify a California Income Tax Calculations for Multistate Businesses Initiative, the "[California Clean Jobs Energy Act](#)," (#11-0080) were filed with the Secretary of State on May 4, 2012. The initiative would require multistate businesses to calculate their California income tax liability utilizing a single sales factor apportionment formula and would repeal existing law giving multistate businesses an option to choose an apportionment formula that provides favorable tax treatment for businesses with property and payroll outside of California.

What about the MTC apportionment election?

Gillette and Budget Trailer Bill Language. California's membership in the Multistate Tax Compact ("MTC" or the "Compact") dates back to the 1970's. The Compact adopts the Uniform Division of Income for Tax Purposes Act ("UDITPA"). Article III of the Compact provides taxpayers the option of apportioning their income using an equally-weighted formula of property, payroll and sales.

On May 8, 2012, the California Court of Appeals heard oral arguments in the case of *The Gillette Company & Subs. v. Franchise Tax Board*. The Franchise Tax Board refused to allow Gillette to make the MTC election to use an equally-weighted apportionment formula. Notwithstanding the MTC, during the tax years at issue California businesses were required to apportion their income using a double-weighted sales formula. (Click here for more on *Gillette*)

The Court of Appeals has 90-days from the date of oral arguments to issue its decision.

At issue is whether a taxpayer victory in *Gillette* will override any legislative enactment mandating single sales factor apportionment. Also of importance is the release by both the California Assembly and the Senate on June 13, 2012, of amended language to budget bills that would repeal all provisions in California law related to the Multistate Tax Compact (see [A.B. 1475](#) and [S.B. 1015](#)), thus negating the impact of a decision mandating the option of a equally-weighted three factor formula election found under the Compact.

PwC Observes

Michael Herbert, PwC Partner in San Francisco, CA, filed the original MTC claims. He provides the following observation:

"Without question, uncertainty is the currency of the California tax system for taxpayers right now -- should they elect single sales factor apportionment with market-based sourcing, opt for California's double-weighted sales factor, or consider filing under the MTC provisions or make some sort of protective election? However, a word of caution for those considering the MTC provisions: the MTC carries with it differences aside from the weighting of the sales factor."

"One bit of certainty exists if *Gillette* is decided favorably for the taxpayer in that single sales factor apportionment will not be mandatory without California's withdrawal from the Compact. However, withdrawal could happen if the budget trailer bills mentioned above are passed. Taxpayers should keep in mind Proposition 26 and the requirement for revenue-raising bills to be passed by a 2/3 vote in each house of the legislature ([Proposition 26](#), LAO Analysis, 7/15/10)."

"All of these moving parts are difficult to predict, thus making uncertainty a reality for California taxpayers. Consequently, taxpayers should begin to look at their 2011 filings right now."

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