CORPORATE FRANCHISE AND INCOME TAXES

California Court of Appeal Upholds Taxpayer Option to Use Multistate Tax Compact's Standard Apportionment Formula

The FTB filed a petition seeking California Supreme Court review of the decision in Gillette; if the decision stands, the remaining Compact members that have adopted alternative apportionment formulas might also repeal the Compact.

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A California court of appeal has upheld the option of corporate taxpayers to use the three-factor, equally weighted apportionment formula set forth in the Multistate Tax Compact (the "Compact") rather than a state-adopted formula. In *The Gillette Co. v. Franchise Tax Board,* [1] the court confirmed and clarified its earlier decision in the same matter that was withdrawn for rehearing. The taxpayers had brought the action seeking a refund of California franchise taxes on the grounds that, at their election, they were entitled to use the apportionment formula set forth in the Compact rather than the double-weighted sales factor formula as maintained by the California Franchise Tax Board.

The Multistate Tax Compact

The Compact has its early history in the search for uniformity among the states in the apportionment of corporate income for tax purposes. In 1957, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Division of Income for Tax Purposes Act (UDITPA). [2] UDITPA contains a three-factor formula for apportioning a multistate corporation's business income, with equal weight given to each of the three factors: property, payroll, and sales receipts. California adopted UDITPA in 1966 (codified at Cal. Rev. & Tax. Code §§25120 to 25139).

In 1959, in *Northwestern States Portland Cement Company v. State of Minnesota,* [3] the U.S. Supreme Court upheld state taxation of net income from interstate operations of a foreign (i.e., out-of-state) corporation, "provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same." This decision heightened the concerns of the business community regarding fair taxation of interstate operations. Shortly thereafter, Congress commenced hearings on the issue, which resulted in the enactment of P.L. 86-272, supposedly as an emergency and temporary measure. [4]

Included within P.L. 86-272 was a provision creating a federal congressional panel (the "Willis Committee"), to study state taxes and recommend legislation establishing uniform standards that states could observe in taxing interstate commerce. The panel published its study, commonly referred to as the "Willis Report," which called for federal legislation limiting state authority to tax interstate business operations and imposing a uniform apportionment standard on the states (the report recommended the use of a two-factor formula consisting of property and payroll). [5]

Congress failed to implement the recommendations of the Willis Report, and state tax administrators then drafted the Compact. By

June 1967, nine states had enacted the Compact; California enacted the Compact in 1974 (codified at Cal. Rev. & Tax. Code §38001 *et seq.*).

Article IV of the Compact sets forth UDITPA and, in Art. IV, §9, the equally weighted three-factor apportionment formula. Article III provides that any taxpayer subject to an income tax may elect to apportion and allocate income "in the manner provided by the laws of such state ... without reference to this Compact, or may elect to apportion and allocate in accordance with Article IV" of the Compact. The Compact also created, in Article VI, the Multistate Tax Commission (MTC), with the power to, among other things, (1) study state and local tax systems, (2) develop and recommend proposals for greater uniformity of state and local tax laws, and (3) compile and publish information helpful to the states.

MTC member states.

Prior to the decision in *Gillette,* the MTC had 20 "Compact Members," i.e., states that have enacted the Multistate Tax Compact into their state law. These states (represented by the heads of the tax agencies administering corporate income and sales and use taxes) govern the MTC and participate in a wide range of projects and programs.

The MTC also has two other categories of membership. "Sovereignty Members" are states that support the purposes of the Compact through regular participation in, and financial support for, the general activities of the MTC. These states join in shaping and supporting the MTC's efforts to preserve state taxing authority and improve state tax policy and administration. "Associate & Project Members" are states that participate in MTC meetings and otherwise consult and cooperate with the MTC and its other member states or, as project members, participate in MTC programs or projects. [6]

Among its various activities, the MTC proposes uniform regulations in an advisory capacity, and performs interstate audits, if requested by a party state. [7] States are free to withdraw from the Compact at any time "by enacting a statute repealing the same" (Compact Art. X, §2). As discussed further below, following the decision in *Gillette* California enacted legislation repealing the Compact, and thus changed its status from "Compact Member" to "Associate & Project Member."

Validity of the Compact.

In 1972, a group of multistate corporate taxpayers that were threatened with audits by the MTC initiated a suit challenging the validity of the Compact. In *U.S. Steel Corp. v. Multistate Tax Commission,* [8] the taxpayers brought a challenge under the Compact Clause of the U.S. Constitution, which provides: "No State shall, without the Consent of the Congress, ... enter into any Agreement or Compact with another State, or with a foreign Power...." [9] There, the U.S. Supreme Court found that the Compact Clause is limited to agreements involving combinations tending to increase political power in the states to the detriment of federal supremacy. Since the Multistate Tax Compact did not seek to encroach on federal supremacy, and did not otherwise unconstitutionally regulate the taxation of interstate commerce, the Court found the Compact valid. Further, the Court found that the Compact did not purport to authorize its members to exercise powers that could not otherwise be exercised, nor was there a delegation of sovereign power to the MTC, since each state retained freedom to adopt or reject rules and regulations of the MTC and each state was free to withdraw at any time.

California and the Gillette Case

From the time it enacted the Compact in 1974 until 1993, California required corporations to apportion business income using the standard, equally weighted, three-factor UDITPA formula contained in the Compact. In 1993, California amended the formula to give double weight to the sales factor. The new formula generally was mandatory for all business income. (Cal. Rev. & Tax. Code §25128 (a).) [10]

Initial proceedings.

In January 2010, six corporations filed complaints for refunds of taxes totaling approximately $34 million. The taxpayers asserted that they began filing claims for refund several years earlier, based on their having elected to use the three-factor formula (property, payroll, and single-weighted sales) as specifically provided for in the Compact (Cal. Rev. & Tax. Code §38006). The California Franchise Tax Board (FTB) had denied the refund claims. In their complaints, the taxpayers alleged that §25128, as amended, did not override or repeal the UDITPA formula.

The FTB demurred to the complaints, arguing that §25128 as amended mandated the exclusive use of the double-weighted sales factor, and thus, by its very terms, removed the alternative use of the formula in §38006. The trial court sustained the FTB's demurrer without leave to amend and entered judgment in favor of California. [11]

The appellate court's view.

On appeal before the California Court of Appeal, the taxpayers maintained that the Compact was valid and binding on California during the tax periods in question, and that the legislature could not remove the apportionment formula option contained in the Compact without expressly repealing the entire Compact. The FTB maintained that the taxpayers lacked standing to complain of any purported violation of the Compact and again asserted that the plain language of Cal. Rev. & Tax. Code §25128 mandated the exclusive use of the double-weighted apportionment formula and thus eliminated the option to use the equally weighted three-factor formula. The FTB also argued that the 1993 legislative change, adopting the double-weighted sales factor, was effective to supersede the Compact legislation that had allowed the alternative apportionment formula option.

Interstate compacts. The court first examined the nature of interstate compacts in general. Relying on the U.S. Supreme Court's decision in *Northeast Bancorp, Inc. v. Board of Governors of the Federal Reserve System,* [12] as summarized by the federal Court of Appeals for the Ninth Circuit in *Seattle Master Builders Ass'n v. Pacific Northwest Electric Power and Conservation Planning Council,* [13] the California court noted three principal indicia of a "compact" between or among states. First, a compact provides for the "establishment of a joint organization for regulatory purposes." Second, a compact contains "conditional consent by member states in which each state is not free to modify or repeal its participation unilaterally." Finally, compacts "require reciprocal action for their effectiveness."

The California court stated that where, as in the instant case, federal congressional consent was neither given nor required, an agreement between the states such as the Multistate Tax Compact must be construed as state law. As such, interstate compacts have dual functions as enforceable contracts between member states and as statutes with legal standing within each state. Further, interstate compacts are unique since they empower one state legislature—i.e., the one that enacted the agreement—to bind future state legislatures to certain principles governing the subject matter of the compact. Therefore, a state may not amend a compact by enacting legislation that is substantially similar, unless the compact itself contains language allowing a state to modify it through legislation "concurred in" by the other states.

Standing. The FTB contended that even if California had breached its obligations under the Compact, the taxpayers had no judicial remedy since they were not parties to the agreement and had no enforceable rights under it. The court noted, however, that the taxpayers were seeking an action for the refund of corporate taxes paid to the state and undoubtedly had the right, in such an action, "to claim that the tax computed and assessed is void in whole or in part." (Internal citation and quotation marks omitted.)

Furthermore, the court noted that the Compact, in Art. III, §1, explicitly gives taxpayers whose income is subject to apportionment and allocation under the laws of a party state the option to elect to use the three-factor formula under UDITPA. This, the court said, "is a right specifically extended not to the party states but to taxpayers as third parties regulated under the Compact...." Accordingly, taxpayers may seek to enforce this right as part of the tax refund suit.

Finally, the court found that the stated purposes of the Compact explicitly embrace taxpayer interests. These purposes, the court said, include "facilitating (1) 'proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases,' and (2) 'taxpayer convenience' [Compact Art. I, §§1 and 3]."

The Compact is valid and enforceable. With respect to validity of the Compact, the court referred to the U.S. Supreme Court's decision in *U.S. Steel* upholding the facial validity of the Compact against various constitutional challenges. The court also noted that the California Attorney General had opined that, by enacting the Compact as a state law, the legislature had made California a member of the MTC, and the only way to withdraw from that Commission was by enacting repealing legislation. [14]

Further, the court found that the Compact satisfied the indicia of a compact, noting that the MTC "is an operational body charged with duties and powers in furtherance of the Compact's purposes. It oversees the Compact, is composed of tax administrators from all member states, and is financed through a process of allocation and apportionment.... Meeting on at least an annual basis, and with representation from each signatory state, the [MTC] is a vehicle for continuing cooperative action among those states."

In addition, the court stated that the Compact contains binding and reciprocal obligations that advance uniformity. First, the court noted that, as it had previously discussed, the Compact secures an election for multistate taxpayers to apportion income using either the UDITPA formula or a state's own formula. That election, however, is not optional for party states. According to the court, "[b]ecause any multistate taxpayer 'may elect' either approach, the party states must make the election available." The court quoted the MTC's explanation that the mandate to make UDITPA available to taxpayers on an optional basis preserves "the substantial advantages with which lack of uniformity provides [the taxpayer] in some states." [15] Thus the Compact preserves the right of the states to provide taxpayers with alternative formulas, while at the same time making uniformity available when and where desired.

Finally, the Compact provides for a state's orderly withdrawal, which must be accomplished by enacting a statute repealing the Compact. Any repealing legislation, however, must be prospective in nature so as not to affect any historical liabilities incurred by the state. While notice to sister states is not specifically required, the process itself, by requiring repealing state legislation, calls for a measured, deliberative decision prior to withdrawal. Nevertheless, the right to withdraw is unilateral.

Unilateral repeal of Compact terms. Despite the unilateral right to repeal the Compact and withdraw from the MTC, the language in Cal. Rev. & Tax. Code §25128 mandating use of the state's own apportionment formula "[n]otwithstanding Section 38006" did not constitute a valid repeal as contended by the FTB. Cal. Rev. & Tax. Code §38006 was a codification of the Compact in California. By that enactment, California entered a binding, enforceable agreement with the other signatory states. The Compact superseded subsequent conflicting state law. Furthermore, under both the federal and state constitutions, California could not pass a valid law that impaired the obligations of contracts. [16]

Finally, the court found that the FTB's argument regarding the effect of the amended §25128 ran afoul of the California constitutional provision that states, in part: "A statute may not be amended by reference to its title. A section of a statute may not be amended unless the section is reenacted as amended." [17]

According to the court, the FTB's construct triggered the reenactment statute because it posits that the 1993 amendment to §25128 repealed and superseded the UDITPA apportionment formula. Nevertheless, the purportedly deleted UDITPA election remained in former §38006. The legislature did not repeal, amend, nor reenact any part of the Compact at the time, and thus neither the public nor the legislators had adequate notice that the intent of this amendment was to eviscerate former §38006.

Effect on Future Reporting

Effective 6/27/12, California enacted legislation (S.B. 1015, 6/27/12; Laws 2012, ch. 37) that (in §3) repealed the Multistate Tax Compact (which was codified in Cal. Rev. & Tax. Code Part 18 (§38001 *et seq.*)), including the provision that allowed taxpayers to elect the UDITPA formula for allocation and apportionment. The legislation also provides that any election affecting the computation of tax must be made on the original, timely filed return. [18]

In November 2012, the FTB filed a petition seeking California Supreme Court review of the court of appeal's decision. While such review by the supreme court is discretionary, the MTC, along with 18 Compact members (17 states and the District of Columbia), have filed friend-of-the-court letters in support of the FTB's request for review. [19] After extending, to 2/11/13, its own deadline to decide whether to accept the case, the California Supreme Court, on 1/16/13, did agree to review the court of appeal's decision. [20]

In the meantime, taxpayers may wish to preserve their right to a refund by filing timely claims, both in California and in other Compact states that have adopted a varying formula. For claims to be allowed in California, the decision of the court of appeal must stand and the newly enacted legislation establishing a "doctrine of elections" would have to be held invalid or not applied retroactively. Taxpayers that wish to make the election on newly filed returns should be mindful of the automatic 20% penalty on any understatement of tax exceeding $1 million for any tax year. [21]

Conclusion

As noted above, California has already withdrawn from the Compact. If the *Gillette* decision stands, it is quite possible that the remaining Compact members that have adopted alternative apportionment formulas would also repeal the Compact. Alternatively, the Compact members may decide to amend the Compact itself to remove the UDITPA formula as an alternative for taxpayers. That would likely remove the last vestiges of uniformity in apportionment, one of the principal purposes for the development of the Compact initially. Of course, if the decision in *Gillette* is reversed, and states are free to adopt their own apportionment formulas, uniformity in

apportionment as a major factor under the Compact would also be effectively destroyed.

Sidebar

Practice Note: Filing Protective Refund Claims

In *The Gillette Co. v. California Franchise Tax Bd.,* 209 Cal App 4th 938, 147 Cal Rptr 3d 603, 12 CDOS 11275, 2012 Daily Journal DAR 13662, 2012 WL 4493845 (1st Dist., 2012), as discussed in the accompanying article, a California court of appeal has upheld the option of corporate taxpayers to use the three-factor, equally weighted apportionment formula set forth in the Multistate Tax Compact rather than a state-adopted formula. The FTB has asked the California Supreme Court to review the decision. Accordingly, taxpayers may wish to preserve their right to a refund by filing timely claims, in California as well as in other Compact states that have adopted a varying formula. For claims to be allowed in California, the decision of the court of appeal must stand and the newly enacted legislation establishing a "doctrine of elections" would have to be held invalid or not applied retroactively.

Exhibit 1. Multistate Tax Commission Members (see www.mtc.gov)

Compact Members	Sovereignty Members	Associate & Project Members
Alabama	Georgia	Arizona
Alaska	Kentucky	California
Arkansas	Louisiana	Connecticut
Colorado	New Jersey	Florida
District of Columbia	South Carolina	Illinois
Hawaii	West Virginia	Indiana
Idaho		Iowa
Kansas		Maine
Michigan		Maryland
Minnesota		Massachusetts
Missouri		Mississippi
Montana		Nebraska
New Mexico		New Hampshire
North Dakota		New York
Oregon		North Carolina
South Dakota		Ohio
Texas		Oklahoma
Utah		Pennsylvania
Washington		Rhode Island
		Tennessee
		Vermont
		Wisconsin
		Wyoming

[1] 209 Cal App 4th 938, 147 Cal Rptr 3d 603, 2012 WL 4493845 (1st Dist., 2012), *vac'g* 144 Cal Rptr 3d 555, 2012 WL 3008238 (Cal. Ct. App. 1st Dist., 2012).

[2] 7A Uniform Laws Annotated (West Publishing, 2002), Pt. 1, pages 141-142, and §9. The National Conference of Commissioners on Uniform State Laws (NCCUSL) is a nonprofit, unincorporated association created in 1892; it comprises more than 300 "uniform law commissioners," all members of the bar qualified to practice law. The commissioners are practicing lawyers, judges, law professors, and legislators who are appointed by the states (as well as by the District of Columbia, Puerto Rico, and the U.S. Virgin Islands) to draft proposals for uniform and model laws on subjects where state uniformity is desirable and practicable, and they work toward enactment of those models by the state legislatures. See the organization's website at www.nccusl.org.

[3] 358 US 450, 3 L Ed 2d 421 (1959).

[4] Codified at 15 USC §§381-384, P.L 86-272 (the "Interstate Commerce Tax Act") limits a state's ability to assert income tax jurisdiction over a business whose only activity in the state is the solicitation of orders for sales of tangible personal property, provided the orders are sent out of the state for approval and are filled by shipment from outside the state. P.L. 86-272 does not protect other types of activities in a state and does not apply to non-income taxes (e.g., sales or use taxes) or to the sale of intangibles. See Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 505 US 214, 120 L Ed 2d 174 (1992), which was analyzed in Marcus and Lieberman, "Does *Wrigley* Clarify 'Solicitation' for Purposes of Taxing Interstate Commerce?," 2 JMT 148 (Sep/Oct 1992). See also Lieberman, "MTC Guidelines on P.L. 86-272 Implement the U.S. Supreme Court's Decision in *Wrigley,*" 5 JMT 52 (May/Jun 1995).

[5] *Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary,* H. Rep't No. 1480, 88th Cong., 2d Sess. (1964). Legislation was proposed but not enacted. See H.R. 11798, 89th Cong., 1st Sess. (1965).

[6] See the website of the Multistate Tax Commission (MTC) at www.mtc.gov (click on "Member States" for a listing of the members by category (also provided in Exhibit 1 accompanying this article); then click on "Definition of Members" for an explanation of those categories).

[7] See, e.g., Coalson and Houghton, "Do Multijurisdictional Contingent-Fee Audits Violate Public Policy and Due Process?," 8 JMT 220 (Nov/Dec 1998), which, in part, discusses some court challenges to the MTC's multistate audit program. For more background, see, e.g., Shop Talk, "MTC Seeks Nexus for Marketers Providing In-State Repairs," 6 JMT 43 (Mar/Apr 1996); Shop Talk, "California Reconsiders and Rejects MTC Nexus Bulletin," 6 JMT 94 (May/Jun 1996); Blase, "How to Respond to Audits That Apply the Principles of the MTC's Nexus Bulletin 95-1," 7 JMT 14 (Mar/Apr 1997).

[8] 434 US 452, 54 L Ed 2d 682 (1978). This was one of the cases discussed in Coalson and Houghton, *supra* note 7.

[9] U.S. Const. Art. I, §10, cl. 3.

[10] The standard, equally weighted formula remained in effect for businesses deriving more than 50% of gross business receipts from either agricultural, extractive, savings and loan, or banking or financial business activities. Cal. Rev. & Tax. Code §§25128(b) and (c).

[11] The Gillette Co. v. California Franchise Tax Bd., Cal. Super. Ct., Trial Div., No. CGC-10-495911, 10/25/10, 2010 WL 8022567 .

[12] 472 US 159, 86 L Ed 2d 112 .

[13] 786 F2d 1359 (CA-9, 1986), *cert. den.* U.S.S.Ct., 1/20/87.

[14] Cal. Atty. Gen. Opn. 96-806, 8/5/97 ("the Compact requires California to be a member of the Commission unless and until the Compact is repealed in accordance with its provisions").

[15] "Third Annual Report—Multistate Tax Commission" (Fiscal Year 7/1/69-6/30/70), page 3, "Optional Feature," available on the MTC's website at www.mtc.gov (click on "Annual Report").

[16] "No state shall ... pass any ... law impairing the obligation of contracts" (U.S. Const., Art. I, §10, cl. 1). "A ... law impairing the obligation of contracts may not be passed" (Cal. Const., Art. I, §9).

[17] Cal. Const., Art. IV, §9.

[18] "The Legislature finds and declares the following: (a) The doctrine of election (see generally Pacific Nat. Co. v. Welch, 304 U.S. 191 [20 AFTR 1248] (1938)), provides that an election affecting the computation of tax must be made on an original timely filed return for the taxable period for which the election is to apply and once made is binding. (b) The doctrine of election described in subdivision (a) applies to any election that affects the computation of tax under Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 18401), and Part 11 (commencing with Section 23001) of Division 2 of the Revenue and Taxation Code, unless otherwise provided. (c) Subdivision (b) does not constitute a change in, but is declaratory of, existing law." S.B. 1015, 6/27/12 (Laws 2012, ch. 37), §4.

[19] See Mahoney, "Viability of MTC, Unsettled Legal Questions Call for Court Review of 'Gillette,' FTB Says," BNA Daily Tax Report, 12/17/12, page K-5.

[20] The Gillette Co. v. California Franchise Tax Bd., Cal. S.Ct., No. S206587, *rev. granted* 1/16/13.

[21] See Hull, "New Large Corporate Underpayment Penalty Vexes Taxpayers," 19 JMT 34 (May 2009), and "Appellate Court Upholds Large Corporate Underpayment Penalty," 21 JMT 30 (October 2011).