

California Court of Appeal Issues New Opinion Upholding MTC Election

October 4, 2012

Overview

On October 2, 2012, in *The Gillette Company, et al., v. California Franchise Tax Board* (“*Gillette*”), the California Court of Appeal upheld the right of the taxpayers to elect to apportion and allocate income to California using the Multistate Tax Compact (“Compact”).¹ The Compact, contained in California Revenue and Taxation Code (“CRTC”) Section 38006, includes an equally-weighted three-factor apportionment formula (property, payroll, and sales), rather than the three-factor formula with a double-weighted sales factor generally applicable under the standard apportionment provisions. The Court of Appeal’s October 2nd decision held that electing to use the Compact was a valid option for the taxpayers during the years in question, and that the State was bound by the Compact and its election provision. Although the holding in the case remained unchanged from the court’s prior decision that had been vacated by the court’s motion for rehearing, in its October 2nd decision the court clarified some aspects of the case related to issues raised in briefs filed by the parties after the initial opinion was issued. This External Alert provides some procedural background on *Gillette* and summarizes those items clarified in the court’s analysis.

Procedural Background of *Gillette*

On July 24, 2012, the California Court of Appeal issued its first opinion in *Gillette*. As noted in our July 27, 2012 tax alert,² this taxpayer-favorable decision allowed the taxpayers to elect to apply the Compact’s allocation and apportionment rules, which included an equally-weighted three-factor apportionment formula. However, on August 9, 2012, the court ordered a rehearing of *Gillette* that had the effect of vacating the court’s July 24, 2012 decision.³

Developments in *Gillette* after the Court’s Order for Rehearing

In its opinion issued on October 2nd, which is substantially similar to the one issued on July 24th, the Court of Appeal made changes necessary to reflect the enactment of Senate Bill 1015 (“SB 1015”), which attempted to repeal the Compact.⁴ In a brief filed by the taxpayers after the court issued its July 24th opinion, the taxpayers requested that the court clarify that the Compact was in force during the years at issue despite SB 1015’s attempted repeal of the Compact. While noting in its October 2nd opinion that SB 1015 “and any issue concerning its effect or validity were not before this court[.]” the court concluded that “the Compact is a valid multistate compact, and California was bound by it and its apportionment election provision throughout the years in question....”⁵

Finally, in a brief filed by the Franchise Tax Board (“FTB”) after the court issued its July 24th opinion, the FTB asked the court to clarify whether it had held the standard apportionment formula in CRTC Section 25128 to be unconstitutional. Referencing the constitutional prohibition of laws impairing

¹ *The Gillette Company, et. al. v. California Franchise Tax Board*, No. A130803 (Cal. Ct. App. Oct. 2, 2012). This decision is available at: <http://www.courts.ca.gov/opinions/documents/A130803A.PDF>.

² For a more in-depth summary of the *Gillette* decision, please see our External Tax Alert dated July 27, 2012, accessible at:

http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_tax_multistate_CA_MTC_Alert_7-26-2012.pdf.

³ *The Gillette Company, et. al. v. California Franchise Tax Board*, No. A130803 (Cal. Ct. App. Jul. 24, 2012).

⁴ SB 1015 repealed Part 18 (commencing with Section 38001) of Division 2 of the CRTC. SB 1015 also provided that elections must generally be made on an original timely filed return. The parties to the litigation made elections on amended returns. It does not appear that the Franchise Tax Board had previously raised that issue and the court did not address it, and thus the *Gillette* case may never address this particular issue. For a summary of SB 1015, please see our External Tax Alert dated June 29, 2012, accessible at:

http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_multistate_tax_CA_alert%207-3-12.pdf.

⁵ *The Gillette Company*, No. A130803 (Cal. Ct. App. Oct. 2, 2012), slip op. at 1 (fn1), and 2.

the obligations of contracts (contained in Article I, Sec. 10 of the United States Constitution), the court's October 2nd opinion stated that "during the tax years at issue, section 25128 was unconstitutional as violative of the prohibition against impairing contracts."⁶ This statement may help position the case for possible U.S. Supreme Court review.

Considerations

Based on the Court of Appeal's October 2nd decision in this case, taxpayers may want to consider electing to apply the Compact, both prospectively and retroactively, if the equally weighted apportionment formula and other provisions of the Compact would be beneficial. It is important to note, however, that a taxpayer making the election adopts the full Compact allocation and apportionment regime in place of California's standard regime, and thus we recommend that taxpayers consider whether there are other implications to making the election.

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⁶ *The Gillette Company*, No. A130803 (Cal. Ct. App. Oct. 2, 2012), slip op. at 20.