

California Supreme Court disallows MTC election to change apportionment formula

Overview

On December 31, 2015, the California Supreme Court, in *The Gillette Company, et. al., v. Franchise Tax Board*,¹ unanimously reversed the California Court of Appeal's decision and denied the taxpayers' election to change their corporation franchise tax apportionment formula to apply the provisions of the Multistate Tax Compact (Compact) contained in California Revenue & Taxation Code (CRTC) Section 38006. The taxpayers in *Gillette* sought to use the equally weighted, three-factor apportionment formula (property, payroll, and sales) available under the Compact (Compact Election) in lieu of the three-factor formula with double-weighted sales provided in CRTC Section 25128.

This Tax Alert summarizes the procedural background in *Gillette*, discusses the California Supreme Court's decision, and provides taxpayer considerations concerning the potential implications of that decision.

Procedural background in *Gillette*

The Gillette Company and similarly situated taxpayers filed suit for a tax refund based on the claim that they had a right to make a Compact Election to apportion their income, resulting in the application of the Compact's apportionment formula.² The trial court dismissed the suit on the grounds that the Compact Election was not available to taxpayers as a matter of law. The California Court of Appeal reversed the trial court's judgment, concluding that: (1) the Compact was a valid, enforceable interstate compact that could not be unilaterally altered or amended, and superseded other statutes; (2) CRTC Section 25128 violated the Contract Clause under both the United States and California Constitutions; and (3) CRTC Section 25128 violated the reenactment rule of the California Constitution. Therefore, under the Court of Appeal's holding, the taxpayers had the right to make the Compact Election.³

On November 13, 2012, the Franchise Tax Board (FTB) filed a petition for review with the California Supreme Court, which was granted on January 16, 2013.⁴ The court heard oral arguments on October 6, 2015.⁵

California Supreme Court decision

Reversing the California Court of Appeal decision, the California Supreme Court held that the Compact was not a binding reciprocal agreement among the member states; thus the California Legislature may properly eliminate the Compact's election provision. In making this determination, the court applied the following four-factor test derived from *Northeast Bancorp v. Board of Governors, FRS*, 472 U.S. 159 (1985):⁶ (1) whether the Compact created reciprocal obligations among the member states, (2) whether the Compact's effectiveness depended on the conduct of other members, (3) whether any provision prohibited unilateral member action, and (4) whether a joint organization or body had been established to regulate the members.

First, the California Supreme Court determined that the Compact's provision of a taxpayer election to use either the Uniform Division for Income Tax Purposes Act (UDITPA) formula or any other state apportionment formula did "not create an obligation of member states to each other" and that it was "more akin to the adoption of a model law rather than the creation of any mutual obligations among Compact members."⁷ Second, the court found that the Compact's effectiveness did not depend on the conduct of other members because the Compact was effective before California joined in 1974, given that the required seven states had previously enacted it into law.⁸ Also, the

¹ *The Gillette Company, et. al. v. California Franchise Tax Board*, Case No. S206587 (Cal. 2015), available [here](#).

² Note that a successful Compact election generally replaces California's allocation and apportionment regime with the Compact's regime under CRTC Section 38006, which includes the Compact's apportionment formula.

³ *The Gillette Company, et. al. v. California Franchise Tax Board*, 209 Cal. App. 4th 938 (2012). A discussion of the Court of Appeal's decision is available [here](#).

⁴ See California Courts, *Appellate Court Case Information* available [here](#).

⁵ *Id.*

⁶ In its opinion, the California Supreme Court noted that the Multistate Tax Commission filed an amicus curiae brief in which it stated that the Compact, in its view, was not binding and urged the court to apply the four-factor test derived from *Northeast Bancorp v. Board of Governors* in support of that interpretation. *The Gillette Company, et. al. v. California Franchise Tax Board*, Case No. S206587, slip op. at 9-10.

⁷ *Id.* at 11-12.

⁸ *Id.* at 12-13.

fact that the states can unilaterally join and withdraw from the Compact weighed against a finding that the Compact was a binding interstate agreement.⁹ Third, the court determined that neither the express language of the Compact nor any California enabling statute prohibited unilateral amendment of California's law and noted that the history of the Compact "is replete with examples of unilateral state action" and that, currently, only seven of the 16 Compact members use the equally weighted UDITPA formula.¹⁰ Finally, because the Multistate Tax Commission only served an advisory and informational role and lacked any binding authority over the member states, it was not a joint regulatory organization or body.¹¹

The court also addressed whether CRTC Section 25128 violated the reenactment rule of the California Constitution, which provides, in relevant part, that a section of a statute may not be amended unless the section is reenacted as amended.¹² One purpose of that provision was to ensure that legislators were aware of statutory changes when they adopted legislation and to ensure that the public was apprised of changes in the law. On this issue, the court found that, even without reenactment of CRTC Section 38006 to address the statutory change, the Legislature and the public were reasonably notified of the changes in the law because the amendment to Section 25128 requiring the use of the double-weighted sales factor "expressly referenced the Compact, stating that it applied '[n]otwithstanding Section 38006'"¹³

Having determined that the Legislature had the unilateral authority to eliminate the Compact's election provision, the court concluded that the Legislature intended to do so with respect to the apportionment formula.¹⁴ The court determined that there was no ambiguity in the language of CRTC Section 25128, and the legislative history supported the conclusion that "there is no credible argument that the Legislature intended to retain the Compact's election provision."¹⁵

Considerations

The California Supreme Court's decision is not yet final. The plaintiffs/appellants in *Gillette* generally have 15 days from the filing of the California Supreme Court's decision to seek rehearing of this decision.¹⁶ The court may order rehearing or modify its decision until the decision becomes final.¹⁷ The decision becomes final 30 days after the decision is filed unless, before the 30-day period (or any extension thereof) expires, the court orders an extension—not to exceed a total of 60 additional days.¹⁸ As of the date of this Tax Alert, a request for rehearing has not been filed, but the period for doing so remains open.

Over the past several years, taxpayers have faced uncertainties surrounding the practical application of the Compact Election in light of the California Court of Appeal's decision in *Gillette* and its pending appeal. Questions were raised concerning various potential ramifications of a Compact Election relating to areas such as the weighting of the apportionment formula, the definition of "gross receipts," allocation of certain nonbusiness gains and losses, the effect of making the Compact Election in lieu of industry-specific apportionment regulations, and others. As a result of the California Supreme Court's decision in *Gillette*—assuming the decision goes final in its current form and absent a successful petition for a writ of certiorari to the United States Supreme Court—the weighting of the apportionment formula pursuant to the Compact Election has been resolved for California tax purposes in favor of the state.

Although the terms used by the California Supreme Court in its decision appear to address the Compact Election in its entirety,¹⁹ the issue involved in the case dealt only with taxpayers seeking to make the Compact Election for purposes of applying the equally weighted, three-factor apportionment formula. Some companies have made or considered making the Compact Election for other, non-factor weighting applications of the Compact's allocation and apportionment provisions (as noted above). Such taxpayers may need to reconsider, in consultation with their qualified tax advisers, the viability of such positions given the court's general references to the Compact Election.

⁹ *Id.* at 13.

¹⁰ *Id.*

¹¹ *Id.* at 14-17.

¹² The reenactment rule derives from Article IV, section 9 of the California Constitution, stating: "A statute shall embrace but one subject, which shall be expressed in its title. If a statute embraces a subject not expressed in its title, only the part not expressed is void. A statute may not be amended by reference to its title, only the part not expressed is void. A section of a statute may not be amended unless the section is re-enacted as amended." *The Gillette Company, et. al. v. California Franchise Tax Board*, Case No. S206587, slip op. at 17.

¹³ *Id.* at 18.

¹⁴ *Id.* at 18-19.

¹⁵ *Id.* at 19.

¹⁶ Cal. R. of Ct., tit. 8, R. 8.268(b)(1); 8.536(b).

¹⁷ Cal. R. of Ct., tit. 8, R. 8.264(c); 8.268(a); 8.532(c); 8.536(a).

¹⁸ Cal. R. of Ct., tit. 8, R. 8.532(b).

¹⁹ In its opinion, the California Supreme Court stated that it "conclude[s] the Legislature may properly preclude a taxpayer from relying on the Compact's election provision." *The Gillette Company, et. al. v. California Franchise Tax Board*, Case No. S206587, slip op. at 2.

Although the opinion seems to address the Compact election in its entirety when evaluating whether the Compact is a binding obligation among the member states, the opinion does not specifically address how the reenactment rule of the California Constitution might apply in situations where the Compact Election was made and the affected apportionment provisions do not expressly reference CRTS Section 38006, the Compact elements of California law. As to such situations, it remains unclear to some how the aspect of the court's opinion addressing the Legislature's intent to supersede the Compact's election provision may apply.

Also, the California Legislature's June 2012 enactment of Senate Bill 1015 (S.B. 1015) has further complicated these matters. Enacted in anticipation of a taxpayer-favorable decision in *Gillette*, S.B. 1015 withdrew California from the Compact, and provided a "clarification" that any election affecting a taxpayer's computation of tax must be made on an original, timely-filed return (referring broadly to the "doctrine of election"). However, the validity of S.B. 1015 has been questioned because it was passed by only a simple majority and not the two-thirds majority required for state statutory changes that result in any taxpayer paying a higher tax.²⁰ Some have also questioned whether the legislative reference to the doctrine of election was truly a "clarification" of existing law and whether the doctrine would apply to the Compact Election. In its December 2015 decision, the California Supreme Court explicitly stated that the *Gillette* case does not involve application of S.B. 1015.²¹ It is conceivable that some taxpayers may consider continuing to take certain Compact-based positions, based upon asserted uncertainty of S.B. 1015's application.

Compact Election issues similar to those at stake in *Gillette*—including whether the Compact creates binding obligations among member states and the constitutionality of state provisions that alter, amend, supersede, and/or repeal the Compact—have been moving through the courts in various other states, with most holdings to date in favor of the states. However, it is conceivable that courts in other states ultimately could conclude differently on similar issues that, along with the constitutional issues involved, may possibly provide grounds for United States Supreme Court review. A petition for a writ of certiorari will be granted only for compelling reasons,²² and generally must be filed within 90 days after entry of a state supreme court judgment.²³

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²⁰ This mandatory two-thirds vote is required under Article XIII A, Section 3(a) of the California Constitution (Proposition 26).

²¹ *The Gillette Company, et. al. v. California Franchise Tax Board*, Case No. S206587, slip op. at 7, n.6.

²² U.S. Sup. Ct. R. 10.

²³ U.S. Sup. Ct. R. 13.