Oregon Tax Court disallows "Compact" apportionment election

Overview

In *Health Net, Inc. and Subsidiaries v. Department of Revenue,* the Oregon Tax Court (Tax Court) recently determined that when the Oregon Legislature enacted Or. Rev. Stat. § 314.606 in 1993, the Legislature "effectively disabled" the ability of taxpayers to make an election under the Multistate Tax Compact (Compact) to use the equally weighted, three-factor (sales, property, and payroll) apportionment formula.[1] The Tax Court also ruled that the enactment of Or. Rev. Stat. § 314.606 did not violate any procedural or substantive provision of the Oregon Constitution, and did not violate the federal Compact Clause or the federal Contract Clause of the U.S. Constitution.[2]

On this basis, the Tax Court ruled that Health Net, Inc. and Subsidiaries, a federal affiliated group (the taxpayer), could not elect to compute its Oregon corporate income tax liability for the 2005 through 2007 tax years pursuant to the Compact's equally weighted, three-factor apportionment formula.[3] Accordingly, the taxpayer is required to use Oregon's single sales factor apportionment formula as provided in Or. Rev. Stat. § 314.650.

The taxpayer has 30 days from the date of the Tax Court's judgment to appeal this matter to the Oregon Supreme Court.[4] As of the release date of this Tax Alert, the taxpayer has not filed an appeal, although the appeal period remains open. Accordingly, the case is not yet final.

This Tax Alert summarizes the Tax Court's decision in *Health Net* and provides taxpayer considerations.

Background

The Compact, which became effective in 1967, was created by the states in response to federal proposals to regulate state taxation through the adoption of a uniform method of apportionment for state net income tax purposes. As part of the Compact, Article IV incorporates—almost verbatim—the provisions of the Uniform Division of Income for Tax Purposes Act, which provide for an equally weighted, three-factor apportionment formula. In addition, Article III of the Compact permits taxpayers to elect (Compact Election) to use the income apportionment provisions of Article IV in lieu of other income tax apportionment rules that may be adopted by the member states.

For all tax years at issue in this case, Oregon was a full member of the Compact. And, until 1989, Oregon's statutory apportionment formula—which was provided in Or. Rev. Stat. § 314.650—was identical to the Compact's equally weighted, three-factor formula—provided in Or. Rev. Stat. § 305.655, Article IV.[5] However, starting in 1989, and first effective in 1991, Oregon began amending Or. Rev. Stat. § 314.650 to increase the weighting of the sales factor, ultimately adopting a single sales factor formula effective in 2005.[6]

Accordingly, starting in 1991, a taxpayer could make the Compact Election in Oregon and use the Compact's equally weighted, three-factor formula rather than Oregon's statutory formula. Prior to 1991, the Compact Election could be made but would not have resulted in the calculation of a different apportionment percentage.

In 1993, the Oregon Legislature enacted Or. Rev. Stat. § 314.606, which provided that if the statutory apportionment provisions in Or. Rev. Stat. §§ 314.605 to 314.675 were "inconsistent" with the Compact provisions in Or. Rev. Stat. § 305.655, the statutory apportionment provisions in Or. Rev. Stat. §§ 314.605 to 314.675 "shall control."[7]

On its originally filed Oregon corporate excise tax returns for tax years 2005 through 2007, the taxpayer computed Oregon taxable income using the statutory single sales factor formula. However, in 2010, the taxpayer timely filed amended returns as claims for refund electing to apportion its Oregon taxable income using the Compact's equally

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[1] *Health Net, Inc. and Subsidiaries v. Department of Revenue,* TC 5127, at 50 (Or. Tax, Sept. 9, 2015) (Order Denying Plaintiff's Motion for Summary Judgment and Granting Defendant's Cross-motion for Summary Judgment). A copy of the Tax Court's Order is available here.
[2] *Id.*
[3] *Id.*
[4] Or. Rev. Stat. § 19.255(1); Or. R. App. Proc. Rule 2.05. This 30-day period will commence on the date of the judgment, which is not the date the decision was filed (i.e., Sept. 9, 2015). The prevailing party (in this case, the Oregon Department of Revenue) must submit a draft judgment to the court and the losing party (i.e., the taxpayer) has 10 days to object to the form of the judgment. See Or. Tax Court Rule 70.C.
[5] *Health Net, Inc. and Subsidiaries*, at 8.
[6] *Id.*
[7] *Id.*

weighted, three-factor formula provided in Or. Rev. Stat. § 305.655, Article IV. The Oregon Department of Revenue (Department) denied the refund claims and upheld its own denial on appeal. The taxpayer appealed the matter to the Tax Court.

Oregon Tax Court decision—Compact Election invalid

The Tax Court noted the agreement of the taxpayer and the Department that, absent Or. Rev. Stat. § 314.606, a "taxpayer could elect either the single-factor sales formula … or the three-factor formula under the Compact."[8] However, the Department contended that Or. Rev. Stat. § 314.606 "effectively disabled" the Compact Election.[9]

The taxpayer disagreed, arguing that Or. Rev. Stat. § 314.606 did not disable the Compact Election for various reasons, including, *inter alia*, that: the Compact Election is not "inconsistent" with Oregon's statutory apportionment regime, the statute violated the Contracts Clauses of both the U.S. and Oregon Constitutions, and the statute violated the Compact Clause of the U.S. Constitution.[10] The Tax Court addressed each of these arguments, consistently finding that Or. Rev. Stat. § 314.606 validly disabled the Compact Election without violating the various provisions of the U.S. and Oregon Constitutions.

- **Effective disablement of Compact Election:** The taxpayer argued that Or. Rev. Stat. § 314.606 did not disable the Compact Election because the election is not inconsistent with Oregon's statutory single sales factor apportionment formula. Rather, the taxpayer argued that Or. Rev. Stat. § 314.606 "provides two formulas and inconsistency is determined by looking to the Compact, including the Compact Election."[11] After acknowledging that the statute was ambiguous, the Tax Court provided an extensive analysis of the 1993 legislative history of Or. Rev. Stat. § 314.606, and concluded that the record indicated a clear intent by the Legislature "to disable the Compact Election when it enacted ORS 314.606."[12]
- **No Oregon Contracts Clause violation:** The Oregon Constitution provides that "No … law impairing the obligation of contracts shall ever be passed."[13] The taxpayer argued that the Compact created a binding contract when adopted by Oregon, and therefore the enactment of Or. Rev. Stat. § 314.606 violated the Oregon Contracts Clause. To address this issue, the Tax Court conducted an exhaustive analysis of whether a contract was created. For various reasons, the court concluded that no contract was created by Oregon's adoption of the Compact. Relative to the essential contractual element of consideration, the Tax Court observed that Article X(2) of the Compact specifically grants its members the right to withdraw at any time, which effectively allows members to unilaterally relieve themselves of the obligations of Compact membership. As explained by the Tax Court, this "unfettered right to terminate an agreement without notice leads to a failure of consideration …."[14] Further, a party's "unlimited discretion to relieve itself of [an] obligation … render[s] [that] contract illusory."[15] The Tax Court cited other elements of the Compact—as well as the practices of member states—in reaching its conclusion that no contract was formed by the states in their adoption of the Compact, including that the Compact does not clearly and unambiguously indicate an intention to bind the future legislatures of the states,[16] nor have states objected when other member states have amended their state version of the Compact.[17] Ultimately, in the opinion of the Tax Court, insufficient reciprocal promises existed among Compact members to support the finding of a contract.[18] Accordingly, in the absence of a contract, the Tax Court found there could be no violation of the Oregon Contract Clause.[19]
- **No federal Contracts Clause violation:** The Tax Court also addressed whether Or. Rev. Stat. § 314.606 violated the Contracts Clause of the U.S. Constitution that provides: "No State shall … pass any … Law impairing

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[8] *Id.*
[9] *Id.*
[10] *Id.* at 7. The taxpayer also contended that Or. Rev. Stat. § 314.606 violated the Full Text provision of the Oregon Constitution (Or. Const., Art. IV, § 22), which is generally intended to promote clear and unambiguous legislation particularly in the context of revisory or amendatory laws. The Tax Court found that Or. Rev. Stat. § 314.606 "[d]oes not purport to amend the Compact … [i]t is an independent, complete law," and therefore did not violate the Full Text provision. *Health Net, Inc. and Subsidiaries*, at 14.
[11] *Id*. at 9.
[12] *Id.* at 12, 50.
[13] *Id.* at 14, citing, Or. Const., Art. I, § 21.
[14] *Health Net, Inc. and Subsidiaries*, at 17.
[15] *Id*. at 18, citing, *Furrer v. Southwest Oregon Community College*, 196 Or. App. 374, at 380 n1 (2004) (additional citations omitted).
[16] *Health Net, Inc. and Subsidiaries*, at 27. The Tax Court further observed that in alleged contracts between private parties, implied covenants of good faith and fair dealing may play a role, but these implied covenants "have no place when the question is whether a statutory contract binding later legislatures exists. In those cases the test of clear and unambiguous expression does not permit implication of terms." *Id.* at 19-20, n. 12 (citations omitted).
[17] *Id.* at 25, 27.
[18] *Id.* at 27.
[19] *Id.*

the Obligation of Contracts[.]"[20] The Tax Court began its analysis of whether the federal Contracts Clause has been violated by restating its earlier finding that "no contract exists under Oregon law."[21] Accordingly, "It follows that there can be no impairment of contract for purposes of the federal Contract Clause."[22] The Tax Court then noted, however, that even if "the Compact constitutes a contract, in some cases state restrictions do not amount to "impairments of the obligation of contract in violation of the federal Contract Clause."[23] As explained by the Tax Court, the U.S. Supreme Court in its prior decisions has "never given a law which imposes unforeseen advantages or burdens on a contracting party constitutional immunity against change."[24] Thus, a law that imposes "unforeseen advantages or burdens" may be altered without violating the federal Contract Clause. Further, "laws which restrict a party to those gains reasonably to be expected from the contract are not subject to attack under the Contract Clause, notwithstanding that they technically alter an obligation of a contract."[25]

Applying these concepts, the Tax Court determined that Oregon's adoption of the Compact, if it is in fact a contract, resulted in unforeseeable advantages and burdens stemming in part from the U.S. Supreme Court's decision in *Moorman MFG. Co. v. Bair*[26] that found Iowa's use of single sales factor apportionment to be constitutionally permissible. The Tax Court explained that *Moorman* opened the door for other states to adopt a single sales factor with the states pursuing the dual goals of raising revenue by capturing more income from out-of-state businesses and favoring in-state business over out-of-state business.[27] While a single sales factor would generally reduce the tax burden of in-state companies, it would tend to increase the tax burden of companies with property and personnel outside the state. It is this unequal tax treatment, and the reaction thereto by in-state and out-of-state companies, that created unforeseen consequences that required Oregon to adopt Or. Rev. Stat. § 314.606, effectively disabling the Compact. As explained by the Tax Court:

> In adopting single sales factor apportionment formulas, states like Oregon were faced with a potential fiscal disaster unless the provisions of the Compact Election were either amended or disabled. Absent that, in-state taxpayers would reduce their tax burdens by … [applying] a single sales factor approach. However, out-of-state taxpayers would elect to file under the three-factor formula of the Compact. The taxpayers would not be treated uniformly. Further, the lack of uniformity would result in both in-state and out-of-state companies getting the most advantageous treatment. Revenue increases from out-of-state companies—expected to offset loss of revenue from in-state companies—would never materialize.[28]

It is within this context that the federal Contract Clause limitation on the impairment of a contract is to be applied. As explained by the Tax Court, "No party should be subject to 'unforeseen advantages or burdens[,]' [and t]he party claiming the benefit of a contract must be limited to 'gains reasonably expected.'"[29] In updating its apportionment statutes by adopting Or. Rev. Stat. § 314.606, which effectively disabled the Compact, Oregon "took steps … to protect its revenue and to place all taxpayers on the same footing[,]" steps necessary in order for the state to respond to the "unforeseen burdens" of reduced revenue resulting from the lack of uniformity.[30] As applied to the taxpayer, in the absence of Or. Rev. Stat. § 314.606, an "unforeseen advantage" would arise as the taxpayer would be getting "most advantageous treatment" by being able to avoid single sales factor apportionment by making a Compact Election.[31] Regarding whether this benefit (i.e., the ability to rely on the availability of the Compact) on behalf of the taxpayer is one that could be "reasonably expected," the Tax Court concluded that it could not, stating, "there is nothing in the record that provides any support for a reasonable inference … that taxpayer ever expected the actions of the Compact states and the Compact Election to involve a binding agreement."[32] Based on the foregoing, the Tax Court concluded: "The adoption of ORS 314.606 was not a violation of the federal Contract Clause."[33]

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[20] *Id.* at 28, citing U.S. Const., Art I, § 10.
[21] *Health Net, Inc. and Subsidiaries*, at 30.
[22] *Id.*
[23] *Id.*
[24] *Id.* at 32, citing *Honeyman v. Jacobs*, 306 U.S. 539 (1939); *Gelfert v. National City Bank*, 313 U.S. 221 (1941); *East New York Savings Bank v. Hahn*, 326 U.S. 230 (1945).
[25] *Health Net, Inc. and Subsidiaries*, at 32.
[26] 437 U.S. 267 (1978).
[27] *Health Net, Inc. and Subsidiaries*, at 33. Regarding the benefit to in-state businesses, the Tax Court referenced Justice Blackmun's dissent in *Moorman*, "Justice Blackmun observed that the Iowa formula was parochial in nature, favoring in-state business over out-of-state business." *Id.* Justice Blackmun "also predicted that the majority's conclusion was bound to result in adoption by other states of singles sales factor formulas, as they would perceive or imagine 'a similar advantage to local interests.'" *Id.*, citing *Moorman,* 437 U.S. at 282.
[28] *Health Net, Inc. and Subsidiaries*, at 34-35.
[29] *Id*. at 35, citing *El Paso v. Simmons*, 379 U.S. 497, 515 (1965).
[30] *Health Net, Inc. and Subsidiaries*, at 35.
[31] *Id.*
[32] *Id*. at 36.
[33] *Id*.

- **No Compact Clause violation:** The Tax Court also extensively analyzed the question of whether Or. Rev. Stat. § 314.606 violated the Compact Clause of the U.S. Constitution, which provides that "No State shall, without the Consent of Congress, … enter into any Agreement or Compact with another State."[34] After examining numerous cases and secondary sources, the Tax Court concluded:

  > [T]here is simply no authority for the proposition that under the Compact Clause, an independent limitation on state legislatures exists *when no approval by Congress was necessary or given*. Limitations do exist in such cases. However, … *in the absence of approval of a compact by Congress*, [the limitations] derive from either state or federal Contract Clauses. The label "compact"' does not have a talismanic power to create a substantive limitation on the actions of state legislatures.[35]

Ultimately, the Tax Court did not sustain any of the arguments made by the taxpayer. The Tax Court thus upheld the Department's denial of the taxpayer's refund claim, holding:

> The actions of the legislature of Oregon in adopting ORS 314.606 were for the purpose of disabling the Compact Election. That legislative action violated no procedural or substantive provision of the Oregon Constitution. It violated no provision of federal statutory law. It did not violate the Compact Clause or the Federal Contract Clause.[36]

Considerations

As noted previously, as of the release date of this Tax Alert, an appeal has not been filed. However, the period for filing an appeal in this case remains open. Accordingly, the case is not yet final.

The Department previously published guidance for how taxpayers could submit protective claims for refund electing to apportion Oregon taxable income using the Compact's equally weighted, three-factor formula pending the outcome of this case.[37] In the event that this Tax Court decision is appealed, it is conceivable that protective claims may continue to be filed. Taxpayers who have made the Compact Election on previously-filed returns that are not protective claims can expect to receive notices (to the extent they have not already) from the Department adjusting or rejecting Compact-based elements of the apportionment factor. Taxpayers should consult with their qualified professional advisers regarding how to proceed in light of this Tax Court decision.

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[34] *Id.* at 36, citing, U.S. Const., Art. I, § 10.
[35] *Health Net, Inc. and Subsidiaries*, at 49 (emphasis added).
[36] *Id.* at 50.
[37] Please see our Sept. 26, 2012 Tax Alert on this topic available here.