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California Supreme Court Rules Against Taxpayers in Multistate Tax Compact Apportionment Case

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Reversing the California Court of Appeal in a case in which the issue was whether, for years between 1993 and 2005, multistate businesses (Taxpayers) could elect the standard, i.e., equal-weighted, 3-factor apportionment formula set forth in the Multistate Tax Compact (Compact) for purposes of apportioning their business income to California or were required to use the double-weighted sales factor apportionment formula set forth in **Cal. Rev. & Tax. Cd. § 25128(a)** , the California Supreme Court has held that the Taxpayers could not elect the standard 3-factor formula. The Legislature may and did properly preclude them from electing it. In reaching its decision, the court determined that the Compact constitutes state law, that the Compact is not a binding reciprocal agreement among the states that are a party to it, that the reenactment rule did not bar the Legislature from amending **Cal. Rev. & Tax. Cd. § 25128(a)** , and that the Legislature not only could eliminate the Compact's election provision but also intended to eliminate it. As a result of the Supreme Court's decision, the Taxpayers are not entitled to an income tax refund of approximately $34 million, the amount of refund to which they would have been entitled had they been able to use the standard 3-factor formula for the years at issue. (The Gillette Co., et al. v. Franchise Tax Bd., Cal. S. Ct., **Dkt. No. S206587, 12/31/2015.**)

Background. In 1966, California codified the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), one of which was the standard 3-factor formula for apportioning business income.

In January 1967, a draft of the Compact was presented to the states, and nine states adopted it within six months. The Compact includes two central features: the creation of the Multistate Tax Commission (Commission) and the adoption of the UDITPA's equal-weighted, i.e., the standard, 3-factor apportionment formula. The Compact contains an election provision: a taxpayer subject to apportionment of income could elect either the Compact's election formula or the state's election formula.

In 1974, the California Legislature enacted former **Cal. Rev. & Tax. Cd. § 38006** , which included the entire text of UDITPA, and made California a member state of the Compact.

Until 1993, the Compact's election formula and California's election formula were the same, i.e., the standard 3-factor apportionment formula. In 1993, California amended its apportionment formula by amending **Cal. Rev. & Tax. Cd. § 25128(a)** to provide that "Notwithstanding Section 38006 [the provisions of the Compact], all business income will be apportioned to California by using a double-weighted sales factor formula.

Between 1993 and 2005, the Taxpayers paid income tax using the new, i.e., the double-weighted sales factor, apportionment formula, then sought a refund, arguing that the Compact gave them the right to choose between the new legislative formula or the UDITPA approach. The Franchise Tax Board (FTB) rejected their refund claims; the trial court sustained the FTB's demurrer, concluding the Legislature could consistent with the Compact, eliminate the election provision; and the Court of Appeal reversed, reasoning in part that the Legislature could not unilaterally repudiate mandatory terms of the Compact, which permitted the election.

The Supreme Court's analysis. The FTB contends that section 25128's new apportionment formula should control, arguing that when member states entered the Compact their intent was to allow them to change their state laws to establish alternative mandatory apportionment formulas, and the Taxpayers argue that the Compact explicitly permits election and the Legislature is bound by it because interstate compacts take precedence over other state laws. The case turns of whether the Legislature is so bound, and the court concluded it is not and California's statutory formula governs.

The Compact constitutes state law and is not a binding reciprocal agreement. The Taxpayers argue that interstate compacts (approved by Congress or not) take precedence over other state law because they are both contracts and binding reciprocal statutes among sovereign states and thus contend that section 25128 violates the contract clauses of the federal and California constitutions because it impairs an obligation created by an interstate compact, i.e., the right to elect the standard 3-factor apportionment formula. But the court did not have to decide whether an interstate compact not approved by Congress (the Compact was not approved by Congress) necessarily takes precedence over state law. Instead, it evaluated whether the Compact is a binding contract among its members, and concluded it is not. In reaching that decision, the court relied on the view of the Commission, which is that the Compact is not a binding interstate compact but rather an advisory compact that contains two apportionment provisions, and on the analysis in the amicus brief the Commission filed in the case. The Commission's brief identified indicia of binding interstate compacts, indicia that were noted in a U.S. Supreme Court case, e.g., reciprocal obligations among member states, whether the compact's effectiveness depends on the conduct of other members and whether any provision prohibits unilateral member action, and whether the compact establishes a regulatory organization (an organization with regulatory authority over member states), and the California Supreme Court agreed with the Commission that the Compact does not satisfy any of those criteria. Nothing in the language of former section 38006, the circumstances of its enactment, the subsequent conduct of other member states, or

the position taken by the Commission, indicate the California Legislature intended to be bound by the taxpayer election provision in the Compact. Thus, the Legislature had the unilateral authority to eliminate the Compact's election provision.

The Legislature intended to supersede the Compact's election provision. Having concluded that the Legislature had the unilateral authority to eliminate the Contract's election provision, the court then had to determine whether the Legislature intended to do so, and it concluded that it did. The court rejected the Taxpayers' argument that the Legislature intended section 25128's double-sales factor formula to apply only if the Compact formula is not elected, saying both the language of the section ("[n]otwithstanding section 38006, [i.e., the Compact], all business income shall be apportioned to this state by . . . ") and its legislative history defeat such a claim.

The amendment of section 25128 did not violate the reenactment rule. The Taxpayers alternatively argued that the Legislature's amendment of section 25128 is invalid because it violates the reenactment rule. That rule, which is in the California constitution, provides in part that a section of a statute may not be amended unless the section is re-enacted as amended, and the Taxpayers were arguing that former section 38006 had not been re-enacted as amended. One purpose of the reenactment rule is to make sure that legislators and the public are aware of statutory provisions that are being amended. The Legislature's 1993 amendment to section 25128 expressly referenced the Compact, stating that it applied notwithstanding section 38006. Even without a reenactment of section 38006 to eliminate the election language, the amendment of section 25128 did not violate the reenactment rule.

Other state developments. There have been related developments in other states on the issue of a taxpayers' right under the Multistate Tax Compact to elect to apportion income under the original version of UDITPA despite state statutory modifications. Below is a discussion of the issue by Walter Hellerstein, Francis C. Shackelford Professor of Taxation and Distinguished Research Professor, University of Georgia School of Law, taken from the forthcoming 2016-1 supplement to the Jerome R. Hellerstein, Walter Hellerstein & John Swain, State Taxation (Thomson Reuters/Tax & Accounting, 3rd ed., updated tri-annually) (¶ 9.01[1] Taxpayer's Right Under Multistate Tax Compact to Elect to Apportion Income Under Original Version of UDITPA Despite State's Statutory Modifications of UDITPA), which also considers the recent California *Gillette* decision.

Michigan: The Supreme Court of Michigan held that a taxpayer could elect to use the Multistate Tax Compact's three-factor apportionment formula and could not be compelled to use the state's statutorily enacted variation on the standard formula. In International Business Machines Corp. v. Department of Treasury (496 Mich. 642, 852 NW2d 865 (2014), the court held that International Business Machines Corporation (IBM) could employ the Compact formula rather than the single-factor sales apportionment formula that Michigan had adopted under the Michigan Business Tax Act (BTA), which was in force in 2008. In contrast to the California Court of Appeal decision (subsequently reversed by the California Supreme Court), which effectively held that the Compact "trumps" the state statutory provisions, the Michigan court's opinion rested essentially on conventional principles of statutory construction in holding that the legislature had not repealed the Compact's election provision by implication when it enacted the

BTA. After a review of the history of business taxation in Michigan and the controlling principles of statutory construction, the court concluded:

[B]ecause we are able to harmonize the BTA and the Compact's election provision, we conclude that the statutes are not "so incompatible that both cannot stand." We believe that our interpretation allows the Compact's election provision to serve its purpose of providing uniformity to multistate taxpayers in light of Michigan's enactment of an apportionment formula different from the Compact's formula. Any conflict apparent from a first reading of these statutes is reconcilable when the statutes are read in pari materia. Therefore, the Department has failed to overcome the presumption against repeals by implication. Accordingly, the Court of Appeals erred by holding that the Legislature repealed the Compact's election provision by implication when it enacted the BTA. Instead, we hold that the Compact's election provision was available to IBM for the 2008 tax year.

Shortly after the court's decision in IBM, the Michigan Legislature retroactively repealed the law enacting the Compact (effective January 1, 2008). Over state and federal constitutional objections, the Michigan Court of Claims sustained the legislation retroactively repealing the Compact provisions, and it subsequently applied the holdings of these cases to IBM itself, thereby effectively dismissing its claim notwithstanding the Michigan Supreme Court's decision. On appeal, the Michigan Court of Appeals affirmed.

Minnesota: The Minnesota Tax Court concluded that the legislature's repeal of Articles III and IV of the Compact in 1987 properly eliminated taxpayers' option to use the Compact's formula and did not violate either the federal or state contract clauses (Kimberly-Clark Corp. & Subsidiaries v. Commissioner of Revenue, No. 8670-R, Minn. Tax Ct., June 19, 2015; appeal pending (Minn. Sup. Ct.) (No. A15-1322)). The court found that "no Compact provision constituted a clear and unmistakable promise by the state to refrain from using its sovereign power to alter or repeal the apportionment election contained in Articles III and IV."

The court found that in the absence of such an obligation, "taxpayers could have no reasonable expectation that the Legislature would not alter or eliminate the election."[1] Accordingly, the repeal of these articles "did not substantially impair a contractual relationship."

Oregon: In a characteristically thorough and thoughtful ruling by Judge Breithaupt, the Oregon Tax Court concluded that the state legislature's "disablement" of a taxpayer's right to elect the Compact's three-factor formula in lieu of Oregon's single-factor sales formula violated neither state nor federal statutory or constitutional law (Health Net, Inc. v. Department of Revenue, ___ Or. Tax ___ (2015) .). After determining that the Oregon statute "effectively disables the Compact Election,"[2] and that the Compact did not constitute a contract under either the Oregon Contract Clause or the federal Contract Clause, so that its "disablement" violated neither clause, the court addressed the question of whether Oregon's "disablement" of the Compact election violated the Compact Clause. Following a detailed review and analysis of the taxpayer's arguments (and supporting case law), the court found:

At the end of the day ... one conclusion is abundantly clear. Notwithstanding general statements found in

cases and often repeated, there 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, as discussed much earlier in this opinion, in the absence of approval of a compact by Congress, they derive from either the 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.

Texas: The Texas Court of Appeals held that a taxpayer may not invoke the Compact, of which Texas is a member, as the basis for employing a three-factor formula rather than the single-factor gross receipts formula for apportioning Texas's business margins tax (Graphic Packaging Corp. v. Hegar, 471 SW3d 138 (Tex. App.-Austin 2015). Unlike the Compact litigation rulings in other states, however, the Texas ruling did not turn on the question of whether the Compact election was binding on the states. Rather, it turned on the question of whether the election, which applies only to taxpayers "subject to an income tax," applied at all to the business margins tax. The Compact defines an income tax as "a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions." Although other states' courts and administrative tribunals have been divided over the question of whether the Texas business margins tax constitutes an income tax for purposes of statutes denying a deduction for other states' income taxes, the Texas court held that the margins tax was not a net income tax under the Compact. Accordingly, the Compact election simply did not apply, and the court did not address the question that most other courts have confronted, namely, whether the Compact election was binding on states that have adopted other formulas by statute.

Legislative action in response to Compact litigation. As a result of the uncertainty generated by the litigation over the question of whether a taxpayer may elect to apportion its income under the original version of UDITPA rather than the state's modified version in states that are Compact members, a number of states have voted to repeal their Compact membership, although in some cases they reenacted the Compact without the election provision. Thus California, the District of Columbia, Michigan, Minnesota, Oregon, South Dakota, and Utah have all taken such action, although the District of Columbia, Utah, and Oregon reenacted the Compact without the election and apportionment provisions.

Tax Practitioner comments on decision. Below are the comments of Marty Dakessian, Partner, Reed Smith LLP on the decision. Mr. Dakessian was the author of an amicus brief on behalf of the Institute for Professionals in Taxation in support of taxpayers in the *Gillette* case.

On the Gillette opinion: Although I am not surprised by the court's decision, I am disappointed. After watching oral argument and now reading this opinion, I am convinced that the court was more concerned about the doctrine of separation of powers than in holding the FTB and its enablers accountable for their actions. Counsel for Gillette did an outstanding job, but the court simply wasn't willing to make the difficult but correct decision that the FTB and the Legislature overstepped their bounds.

The court had to indulge in this fantasy that the Multistate Tax Compact was basically meaningless in order to get to its conclusion. Because if the MTC is meaningless, then it really doesn't matter that California did not formally withdraw from it-which is how they had to end adherence to the three-factor formula-and something California failed to do.

The opinion's most glaring flaw is that you cannot just say that the Legislature intended to do something and that it has plenary authority and therefore that ends the discussion. We are a society that depends upon fairness and process-concepts that apply with equal force to government actors as they do to private citizens. It is not just that our state government wanted to withdraw from the compact. Did they follow the proper procedures to do so? They did not: California entered into this Compact. The Compact contained withdrawal provisions. California did not follow those withdrawal provisions. Therefore, California is still in the Compact. It is not more complicated than that.

On the irony of the FTB's/MTC's position in this case: I find it totally ironic that in the mid to late 1990s, BOE members Dean Andal and Claude Parrish each pushed for California to formally withdraw from the MTC because it was subjugating California's interests in favor of those of other member states and, at that time, the FTB and the MTC did everything in its power to block it. Now we have the FTB suffering from "buyer's remorse" saying that the Compact is essentially meaningless and that California's membership in the Compact means nothing and now the FTB itself pushing to withdraw from the compact itself. This glaring inconsistency should not be lost on the taxpayer community.

On the prospects of U.S. Supreme Court review: I think the door is open for the U.S. Supreme Court to review this case because of the extensive discussion of whether the MTC is a binding compact and the relevant indicia in making that determination. This is a federal question that implicates dozens of other compacts and thus gives the high court good reason to take the case.

On what this means for the MTC: Since the California Supreme Court has basically said the Compact is meaningless-more akin to model rules than an actual agreement-then we should question why the MTC even exists at this point. The MTC website describes itself as "an intergovernmental state tax agency working on behalf of states and taxpayers to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises." The MTC even uses ".gov" in its domain name-restricted for use by governmental entities. But according the California Supreme Court, this has been nothing more than a charade for the past 40 years. I call on the MTC to recognize it has no purpose at this point and voluntarily dismantle the organization.