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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Calif. Gillette Decision Lends Heft To State Tax Autonomy

By **Eric Kroh**

Law360, New York (January 7, 2016, 9:43 PM ET) -- The California Supreme Court's recent decision that The Gillette Co. could not elect to apportion its taxable income according to the Multistate Tax Compact formula and must instead use the state's modified formula could sway other courts to conclude that states may freely break from the agreement.

The California high court **said in its Dec. 31 opinion** that the compact, which was developed in the 1960s to establish uniformity in how states divvy up the taxable income of multistate companies, is not binding, and furthermore that the state's Legislature had the power to amend it, as it did in 1993 when it required companies to use a different apportionment formula than the one in the compact.

The decision in California, which is the only state supreme court case to date that addresses the issue head-on, is likely to influence courts in other states that are wrestling with the nature of the compact, according to Richard D. Pomp, a tax law professor at the University of Connecticut School of Law.

For example, Pomp said, it might encourage the Oregon Supreme Court to affirm a decision from the state's tax court, which **said in September** that a state law mandating the adoption of a single-factor income apportionment formula based on sales trumped the ability of companies to elect the compact's three-factor formula, which equally weighs a company's property, payroll and sales in a state to determine taxable income.

The Gillette decision stands for the proposition that, "in effect, the compact is nothing more than a state statute that can be amended at will by a legislature," Pomp said. "A state adopting the compact has no obligation to any other state to maintain the integrity of the compact."

A provision of the compact says member states must let taxpayers that operate in multiple states choose whether they will use the compact's three-factor apportionment formula or elect an alternative state formula, if one exists.

California adopted the compact in 1974, but the Legislature passed an amendment in 1993 requiring multistate companies to use a four-factor formula that counted sales twice in the calculation of how much of their income was taxable in the state. Gillette and five other companies filed suit against the California Franchise Tax Board, challenging $34 million in tax assessments by arguing that when states join the compact they cede the right to impose a single taxation formula and must let companies elect the formula spelled out in the agreement.

The FTB suffered a loss in late 2012 when the California Court of Appeal sided with Gillette

and ruled businesses could elect to use the compact's apportionment formula instead of the state's, but that decision was overturned by the California Supreme Court.

Gillette's attorneys have said they will be appealing the decision to the U.S. Supreme Court. Pomp said since there is no split among the state high courts on the compact, the Supreme Court may want to wait until a split develops or at least until other state supreme courts have weighed in on the issue.

Marty Dakessian, a partner with Reed Smith LLP, said he hoped that the high court would take the case, as the questions it raises are compelling ones that need to be resolved.

"The relationship among the states and the nature of agreements among the states is something I think the Supreme Court should be interested in," Dakessian said.

Other states with compact-related litigation underway include Texas, Minnesota and Michigan.

Dakessian said although he was not surprised by the California Supreme Court's decision, given the tenor of oral arguments, he was nevertheless disappointed. The panel appeared to be more concerned with the separation of powers than looking at the compact and applying its provisions, he said.

Dakessian, whose practice focuses on state and local tax issues in California, said that by his reading, the Legislature didn't properly repeal the compact's three-factor apportionment formula when it amended the statute in 1993.

Under Article X of the compact, states must enact a statute repealing the agreement to withdraw from it. The FTB argued that the amendment implied that the compact's three-factor formula was repealed, but in California there is no such thing as repeal by implication, Dakessian said. What's more, the state formally withdrew from the compact in 2011 while the Gillette litigation was ongoing, he said.

"Why would the Legislature do that in 2011 if they thought everything was just fine?" Dakessian said.

Jeffrey A. Friedman of Sutherland Asbill & Brennan LLP said that because the state didn't explicitly repeal the compact election before the years in question in the Gillette case, there is an argument to be made that the election should have been available to the companies. The California Supreme Court gave short shrift to that argument, dispensing with it at the end of the opinion after spending the majority of its discussion on the question of whether the compact is binding on the states, he said.

Gillette's petition to the U.S. Supreme Court will also likely focus on whether the compact is a binding agreement among the states, as it will have to address a question that is under the court's jurisdiction, Friedman said. To make the case more appealing to the justices, Gillette may want to argue that there are differences in the way state courts have interpreted that question such that guidance is needed from the high court, Friedman said.

Regardless of whether the petition is taken up by the U.S. Supreme Court, however, the California Supreme Court's decision is likely to be an influential one that will be taken into consideration by other states' high courts, even if they ultimately come to a different conclusion, Friedman said.

"We'll continue to see state litigation regarding the compact and the compact election," Friedman said. "Those courts will take into account this California decision, although there's no saying as to whether those courts will agree with them."

--Editing by Mark Lebetkin and Philip Shea.