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LEGAL ALERT

October 3, 2012

A Close Shave: California Court of Appeal Rules on Multistate Compact Election

On October 2, 2012, the California Court of Appeal issued an opinion on rehearing in *The Gillette Company et al. v. Franchise Tax Board*, reversing in full the trial court's decision in favor of the Franchise Tax Board (FTB). 207 Cal.App.4th 1369 (Op. on Rehearing, Oct. 2, 2012). Consistent with its original opinion, the Court held California's ratification of the Multistate Tax Compact (Compact or MTC) was a valid contract and therefore the State was bound by the provisions of the Compact during the years at issue, including an election available to corporate taxpayers to apportion income using the Compact's equally weighted, three-factor apportionment formula.

The court's Opinion on Rehearing includes two important changes. First, the court acknowledged California's recent legislative repeal of all provisions related to the Compact (this repeal occurred subsequent to submission of the case by the court after oral argument), expressly noting that any issue concerning the effect or validity of such legislative repeal was not before the court. Second, the court unambiguously held that California's double-weighted sales factor statute (Cal. Rev. & Tax. Code § 25128) was at least in part unconstitutional during the years at issue.

The Original Opinion: The Franchise Tax Board Gets *Creamed*

On July 24, 2012, the court issued its original opinion in *Gillette*, ruling in favor of the taxpayers in the consolidated appeals.

Gillette and five other corporate taxpayers filed suits for refund in 2010, arguing that California's double-weighted sales factor apportionment formula in section 25128 of the California Revenue and Taxation Code, as amended in 1993, did not "override" the Compact's election to apportion using a three-factor apportionment formula.

The court held that the Compact is an enforceable interstate compact, having been ratified by the State, and that California cannot unilaterally repeal Compact terms. The court further held that the State's construction of section 25128 (as prohibiting a Compact election): (1) violates the federal and state constitutional prohibition against impairment of contracts, and (2) runs afoul of the constitutional reenactment rule.

Doctrine of Election: An *Irritation*

On June 27, 2012, only seven weeks after oral argument was heard by the court in *Gillette*, the California Legislature swiftly passed, and the Governor quickly signed, Senate Bill (SB) 1015, prospectively repealing the Compact and acknowledging the "doctrine of election." In short, SB 1015 was aimed at limiting the potential revenue fallout that otherwise would have resulted from a taxpayer victory in *Gillette*—not only with regard to refunds that would have been owed to the taxpayers in *Gillette* but also to all other taxpayers who filed or planned to file similar refund claims.

As expected, the court's opinion on rehearing does not deviate significantly from the original July 24 opinion. There are only two substantive changes. First, the court acknowledged California's repeal of the

Compact for periods following the years at issue and amended language throughout the opinion to the past tense to take into account such repeal. However, the court refused to address—and rightfully so, as suggested in the taxpayers' request to modify the opinion—the effect or validity of the repeal because the issue was not properly before the court. Second, and more importantly, the opinion clarifies that section 25128 of the California Revenue and Taxation Code was unconstitutional during the years at issue. The court's opinion provides:

> Section 25128, by its plain terms, sought to override and disable California's obligation under the Compact to afford taxpayers the option of apportioning income under the UDITPA formula. To this extent, and during the tax years at issue, section 25128 was unconstitutional as violative of the prohibition against impairing contracts.

The above two changes aside, the substance of the court's original opinion remains the same.

Given the broad, sweeping impact of *Gillette*, it is nearly certain that the FTB will seek further review of the decision. The decision becomes final 30 days from the date of filing. Once final, a petition for review with the California Supreme Court must be filed within 10 days. Review by the California Supreme Court is discretionary.

Smooth Sailing in Other States?

The fallout of the Compact litigation is being played out in other states. For example, in Oregon, a similar case to *Gillette* is pending. *Health Net, Incorporated and Subsidiaries v. Department of Revenue* (Case No. 120649D). Oregon adopted the Compact in 1967; however, in 1993, the state enacted Oregon Revised Statute 314.606, which provides that any state-enacted apportionment formula supersedes the one used in the Compact. This case presents many of the same issues (and tax refund opportunities) presented in *Gillette.* The Oregon Department of Revenue alerted taxpayers that it will adjust tax returns that apply the Compact but will defer action on protective refund claims until the *Health Net* litigation is resolved.

On October 3, 2012, the Michigan Court of Appeals, will hear *International Business Machines, Corp v. Dep't of Treasury*, Docket No. 306618, which also concerns the validity of the MTC election.

Similarly, the Texas Comptroller of Public Accounts, in Decisions Nos. 106,508, 106,723, and 107,192, denied refund claims based on an MTC three-factor apportionment formula. Texas adopted the Compact in 1967 and still remains a full member. Litigation is expected to determine whether the Compact's election is available to Texas franchise taxpayers.

Sutherland Observation: While it is unclear whether the California Supreme Court will review *Gillette,* in the interim taxpayers must wrestle with a whole host of issues surrounding the Compact election on current year returns and amended returns for prior years.

For example, does making the Compact election on an amended return violate the doctrine of election? This issue is likely to turn on whether California has the doctrine as part of its law for prior years. SB 1015 specifically provides:

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> This bill would find and declare that the doctrine of election provides that an election affecting the computation of tax must be made on an original timely filed return for the taxable period for which the election is to apply and once made is binding, and that the doctrine of election applies to any election that affects the computation of tax, as specified, which does not constitute a change in, but is declaratory of, existing law.

Does SB 1015 comport with Proposition 26? If not, and the doctrine was not part of California law as to the Compact election, did the Legislature effectively amend the law retroactively? What are a taxpayer's defenses if the law was amended retroactively relative to the doctrine of election issue?

As another example, how do the above issues change or grow for taxpayers seeking to make the election on a current year return (e.g., 2011 corporate returns currently under extension and due by this October 15) instead of amended returns? Assuming SB 1015 is valid and prospective in application, then at a minimum the Compact is still in effect, and taxpayers are forced to decide whether to make the election on the original return. The risks here are significant and may involve application by the FTB of its large corporate understatement penalty (LCUP).

Recall, the LCUP is a strict liability penalty, enacted into law in 2008, and applies to all taxable years beginning on or after January 1, 2003. Cal. Rev. & Tax. Code § 19138. The LCUP applies to corporations that have understatements of tax exceeding $1 million or understatements that exceed 20% of the tax shown on the original or amended return filed by the extended due date, whichever is greater. *Id.* Because the LCUP is a strict liability penalty, it has few exceptions to its imposition. The penalty may be relieved if: (1) the understatement is attributable to a change in law that becomes final after the taxpayer files the return or after the original return's extended due date, whichever is earlier; or (2) the taxpayer's understatement is attributable to reasonable reliance on an FTB Chief Counsel Legal Ruling. Taxpayers may not claim a refund of penalty amounts paid to the FTB unless the FTB erred in computing the penalty. *Id.*

Based on the two extraordinarily limited exceptions to the LCUP and on the lack of finality surrounding *Gillette,* many taxpayers need to take into account the risk of incurring the LCUP by making the Compact election on a current year return.

As a final example, taxpayers should consider the consequences of a Compact election assuming the election is valid. What other aspects of the Compact are/can be applied? The language in Article III of the Compact says the taxpayer "may elect to apportion and allocate his income in accordance with Article IV." Does this mean all of UDITPA (contained in Article IV) is applicable? Similarly, does it mean that California's special industry apportionment rules do not apply? *Gillette* gives taxpayers much to celebrate and much to contemplate.

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