AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

THE SUPREME COURT OF CALIFORNIA UNANIMOUSLY HOLDS THAT THE STATE IS NOT BOUND TO ALLOW THE MTC APPORTIONMENT ELECTION

SUMMARY

On December 31, 2015, the Supreme Court of California decided *Gillette Co. et al. v. Franchise Tax Board*, Docket No. S206587 (Cal. December 31, 2015) in which the court reversed a California Court of Appeal decision in favor of the taxpayers, and unanimously held that the state is not bound to allow the use of the Multistate Tax Commission (the "MTC") election to use an evenly-weighted, three-factor apportionment formula (the "MTC Formula"). Counsel for the taxpayers has indicated that it intends to file a petition for a *writ of certiorari* with the Supreme Court of the United States seeking review of the decision.

DETAILS

Background

California adopted the MTC Compact (the "MTC Compact") in 1974 by enacting section 38006 of the of the California Revenue and Taxation Code ("Section 38006") which contained the MTC Formula and permitted a taxpayer an election to use the MTC Formula or any other apportionment formula provided by state law. Since California had already required an equally-weighted, three-factor formula for apportioning income, the enactment of Section 38006 effectively resulted in a single method of apportioning income to California. However, in 1993, the California Legislature amended section 25128(a) of the California Revenue and Taxation Code ("Section 25128") to read as follows to give double-weight to the sales factor under the state's apportionment formula: "[n]otwithstanding Section 38006, all business income shall be apportioned to this state by multiplying the business income by a fraction,

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the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four[.]"

Gillette and other taxpayers took the position that the 1993 amendment of Section 25128 did not eliminate the ability to elect to use the MTC Formula in lieu of the state's formula. However, the Franchise Tax Board ("FTB") took the position that the enactment of Section 25128 eliminated the elective option contained in Section 38006. This difference in opinions ultimately lead to the decision in *Gillette Co. et al. v. Franchise Tax Board*, 209 Cal.App.4th 938, 147 Cal.Rptr.3d 603 (2012), in which the California Court of Appeal, First District unanimously held that the MTC Compact was a valid and enforceable interstate compact the terms of which the California Legislature could not unilaterally repudiate. Thus, according to the California Court of Appeal, Section 25128 did not eliminate the ability to make an election to use the MTC Formula. The FTB appealed the decision to the California Supreme Court.

The Supreme Court of California's Decision

The court commenced its analysis by addressing whether the MTC Compact was in fact a valid and enforceable interstate compact which the California Legislature could unilaterally repudiate. Based upon the indicia of an interstate compact found in *Northeast Bancorp v. Board of Governors*, 472 U.S. 159 (1985), the court concluded that it was not because: (i) the MTC Compact creates no reciprocal obligations among member states; (ii) the MTC Compact does not depend on the conduct of other members; (iii) no provision in the MTC Compact prohibits unilateral member action; and (iv) the MTC is not a regulatory organization. The court reasoned as follows:

- The taxpayers in *Gillette Co.* admitted that the MTC member states do not perform or deliver obligations to one another and have no incentive to enforce the MTC Compact.
- The MTC Compact expressly grants the authority to join and leave the MTC Compact at will, and only seven of the MTC Compact's current sixteen members employ the MTC Formula.
- No provision in the MTC Compact or California law proscribes unilateral amendment of state law.
- As the MTC observed, its powers are limited to an advisory and informational role. For example, each MTC Compact member state has the power to reject, disregard, amend or modify any rules of regulations promulgated by the MTC. In addition, any auditing power of the MTC is derived from state law.

The court then analyzed whether Section 25128 is invalidated by the Reenactment Rule in section 9, article IV of the Constitution of California (the "Reenactment Rule"), which provides that "[a] section of statute may not be amended unless the section is re-enacted as amended." The court found that the reference to Section 38006 in Section 25128 satisfied a purpose of the Reenactment Rule, which is to make sure legislators do not operate blindly when they amend legislation and the public is apprised of the changes in the law. Thus, the court concluded that Section 25128 was not invalidated by the Reenactment Rule.

The court then considered whether the California Legislature intended to eliminate the MTC Formula when it enacted Section 25128. The court found no ambiguity in the "[n]otwithstanding Section 38006" language in Section 25128 as indicative of the California Legislature's intent to eliminate the MTC Formula election. In addition, the court found the need for amendment expressed in the legislative history accompanying Section 25128 supported the intent of the California Legislature to eliminate the election to use the MTC Formula. As such, the court concluded that there was no credible argument that the Legislature intended to retain the MTC Election.

BDO INSIGHTS

- The decision of the Supreme Court of California in *Gillette Co.* may represent the end of a saga that could ultimately lead to the disallowance of the use of the MTC Formula to apportion income to California in taxable years beginning on or after the effective date of the 1993 amendment to Section 25128. It is estimated that the court's decision could save the state from issuing an estimated $750 million in refunds. However, there is some possibility that the Supreme Court of the United States would accept a petition for *writ of certiorari* filed by the taxpayers in *Gillette Co.* regarding the potential federal Contracts Clause violation (*see* U.S. Const. art. I, § 10, cl. 1) raised by the FTB in their petition for review filed with the Supreme Court of California, and addressed by the parties in their briefs filed with the court, and hold in the taxpayers' favor.

- The Supreme Court of California's decision in *Gillette Co.* could have significant ASC 740 implications for financial reporting purposes for those reporting entities that elected to apply the MTC Formula to reduce their California apportioned income and corresponding tax liability. The decision is considered new information which means reporting entities affected by this decision should consider: (i) whether the position is still sustainable at a "more likely than not" level of assurance; and (ii) the appropriate disclosures that explain their accounting conclusions.