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Gillette Reinstated. If Compact is Elected, LCUP Penalty Shouldn't Apply

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The First Appellate District of the California Court of Appeal has once again held that California taxpayers may avail themselves of the Multistate Tax Compact (the Compact) election, which allows for taxpayers to file returns using the standard Uniform Division of Income for Tax Purposes Act (UDITPA) three-factor formula with equally weighted property, payroll, and sales factors.[1] This published opinion is virtually the same as the opinion the same court issued July 24, 2012, and later vacated. The new opinion contains updated language to reflect the Legislature's attempt to repeal the Compact in a Senate Bill that was passed prior to the first opinion.

1. Background and Summary of the Court's Decision

The *Gillette* decision involves the validity of the election provided in section 38006[2] to apportion and allocate income using the method set forth in the Compact as an alternative to any method otherwise provided by law. The Compact method includes a three-factor apportionment formula giving equal weight to the property, payroll, and sales factors. In 1993, the California Legislature attempted to circumvent the Compact method by amending section 25128, which doubled-weighted the sales factor.

As we discussed in our July 24, 2012 alert, the court held that the Compact election was valid because California had not properly repealed section 38006 and had withdrawn from the Compact. The holding in the court's updated opinion issued October 2, 2012, is unchanged.

As we also discussed in our July 24, 2012 alert, if the Compact election is held to be valid on appeal, we believe that the holding will have additional apportionment implications, including the following:

(a) It may allow taxpayers using special industry formulas and factors (e.g., franchisors, mutual fund service providers) to use the Compact method.

(b) It would deem inoperative California's new definition of gross receipts that excludes treasury and hedging receipts.[3]

(c) It may allow combined reporting groups making the Compact election to compute their sales factors using the Joyce method.[4]

2. Taxpayer Options

In addition to the default apportionment method and the Compact method, California taxpayers, beginning for the 2011 tax year, may elect to apportion business income using a single sales factor method that uses market sourcing. Thus, the court's decision in Gillette leaves taxpayers with three filing options:

(a) **Default method**. Three-factor, double-weighted sales factor, with cost-of-performance sourcing for sales other than sales of tangible personal property.[5]

(b) **Compact method**. Three-factor, single-weighted sales factor, with cost-of-performance sourcing for sales other than sales of tangible personal property.[6]

(c) **Sales-only method**. Sales factor only, with market-based sourcing for sales of services and intangibles.[7]

3. Your Potential Dilemma

One issue that the court expressly did not address was the status of Senate Bill (SB) 1015. This Bill was passed after oral arguments but before the first Gillette opinion was issued. SB 1015 affects the Compact election in two ways. First, SB 1015 attempts to repeal the Compact provisions from the Revenue and Taxation Code. Our opinion is that, if the Court of Appeal's decision in Gillette is ultimately upheld (if it is not reversed by the California or United States Supreme Court), this attempt to repeal the Compact provisions would be invalid under California's Proposition 6 (Cal. Cont., Art. XIIIA, Sec. 3). Proposition 6 requires any change in a state statute that would result in any taxpayer paying a higher tax to be passed by at least two-thirds of all members of both Legislative houses. SB 1015, which would clearly result in at least one taxpayer paying higher taxes, did not meet this requirement.

Despite the Compact repeal likely being invalid, California taxpayers may be deterred from taking a Compact election on their tax returns because of the possible imposition of the 20 percent large corporate understatement penalty[8] (LCUP). This penalty applies to corporate taxpayers with an understatement of tax that exceeds the greater of $1 million or 20 percent of the tax shown on an original return. Thus, California taxpayers may face this penalty if Gillette is later overturned.

The potential for imposition of the LCUP may discourage you from taking the Compact election on an original return and, instead, you may believe taking the election on an amended return is the safe option; but think twice before you make this decision. Consider that the second key feature of SB 1015 is the declaration by the Legislature that the "Doctrine of Election" is California law. SB 1015 defines the Doctrine of Election to require "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."[9] Although we believe that the Doctrine of Election may be inapplicable in this instance and may even violate the Due Process Clause as applied, the FTB's likely position on this issue is that taxpayers would lose the chance to elect the Compact method unless they did so on an original, timely filed return.

4. How to File Your Next Return

In an August 31, 2012 letter, Brian Toman, Reed Smith partner and co-author of this alert, sent a letter to the members of the Franchise Tax Board. In that letter, Brian—who has served in the past as FTB Chief Counsel—requested guidance on how taxpayers should file upcoming returns, which are due October 15 for calendar-year taxpayers filing on extension. Brian stated that the FTB should apply an exception to the LCUP that is reserved for situations exactly like the dilemma such taxpayers may now be facing. Section 19138(f)(1) states, "No penalty shall be imposed … on any understatement to the extent that the understatement is attributable to a change in law that … becomes final after the earlier of …" the date the taxpayer files its return or the extended due date for filing. The term "change in law" is defined specifically for purposes of this exception to include "a statutory change or an interpretation of law or rule of law by … a published federal or California court decision."[10] By the statute's own terms, the FTB is required to "implement this [exception] in a reasonable manner."[11]

A literal reading of the statute, combined with the Legislature's stated intent that the FTB implement the statute, reasonably requires that exception be permitted in this case, where a taxpayer elects to use the Compact method before any final interpretation of the statute forbidding such action. The timing of the issuance of the Court of Appeal's second decision on October—just two weeks before the filing deadline—further justifies a reasonable and lenient approach to the dilemma taxpayers face. Although the Court of Appeal decision is not yet final, it need not be final for the exception to apply. The fact remains that it is the latest statement of the law by any court.

Despite the fact that the Court of Appeal has issued a published opinion prior to the filing deadline, and the fact that there is still no statement of the law that concludes the Compact election is invalid, we have been informed by sources at the FTB that the FTB plans to take the position that taxpayers who make the election on original returns will be subject to the LCUP. The FTB's position relies on the technicality that the Court of Appeal's opinion will not become final until 30 days after it is released—two weeks after the October filing deadline. However, we believe that if the FTB takes this position with respect to returns filed on October 15, this position would be invalidated by courts.

Regardless of when a decision becomes final, a taxpayer must be permitted to rely on a court's statement of the law when filing its return, especially given that its ability to file amended returns adopting the court's decision may be unavailable and could result in the loss of a beneficial tax election. Additionally, under Cal. Rev. & Tax. Code § 19138(f)(1), the penalty can only be imposed on returns filed after an interpretation contrary to the taxpayer's filing position goes final. There is no parallel requirement that an interpretation favoring the taxpayer's position be final for the exception to apply. Thus, the court's second decision on the Compact election only solidifies our belief that taxpayers should be permitted to make a Compact election on their original timely filed returns without the LCUP being imposed. This is the only reasonable method of implementing the statutory exception to the LCUP.

5. Conclusion

Given the Court of Appeal's opinion issued October 2, 2012, we believe that it is appropriate for taxpayers to make Compact elections—if beneficial—on original timely filed returns. If such an election were to later be deemed invalid in the event *Gillette* is overturned by a higher court, the LCUP should not apply because taxpayers made such elections relying on the latest statement of the law, and both a literal reading and the express legislative intent of the statute prohibits imposition of the LCUP.

If you have questions about the *Gillette* case or California apportionment in general, please contact the authors of this alert, or the Reed Smith lawyer with whom you usually work. For more information on Reed Smith's California tax practice, visit www.reedsmith.com/catax.

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1. *The Gillette Company & Subs. v. California Franchise Tax Board*, Cal. Ct. App., 1st Dist., Dkt. No. A130803 (decision issued October 2, 2012; prior decision issued July 24, 2012 and vacated August 9, 2012); appeal from SF Sup. Ct. Dkt. No. CGC-10-495911 (http://www.courts.ca.gov/opinions/documents/A130803A.PDF).
2. All statutory references are to the California Revenue and Taxation Code unless otherwise noted.
3. See Cal. Rev. & Tax. Code § 25120(f)(2).
4. See Appeal of Joyce, Inc., 66-SBE-070, Cal. St. Bd. of Equaliz., Nov. 23, 1996; Cal. Rev. & Tax. Code § 25135(b), added by Ch. 17, Laws 2009 (providing a Finnegan rule for throw-back purposes)..

5. Cal. Rev. & Tax Code § 25128. If an apportioning trade or business derives more than 50 percent of its "gross business receipts" from an agricultural, extractive, savings & loan or banking or financial business activity, an equally weighted three-factor formula of property, payroll and sales is to be utilized to apportion income.
6. Cal. Rev. & Tax Code § 38006 (providing the compact method).
7. S.B.X.3.15 of 2009, Ch. 17, Laws 2009 adding Cal. Rev. & Tax Code § 25128.5 (providing an election to use a single sales factor to apportion income). Under S.B. 858 of 2010, Ch. 721, Laws 2010, § 27, a taxpayer that elects to apportion income using a sales-factor-only must use market-based sourcing. Taxpayers that do not elect to use a sales-factor-only may continue to use cost-of-performance sourcing.
8. Cal. Rev. & Tax. Code § 19138.
9. SB 1015, Sec. 4.
10. Cal. Rev. & Tax. Code § 19138(f)(2).
11. Cal. Rev. & Tax. Code § 19138(f)(3).