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Gillette Wins. You Win. Taxpayers Should Hurry to File California Refund Claims Before the Fall Deadline

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Executive summary and action item

Today, a California Court of Appeal held that taxpayers have the option of electing to single-weight (as opposed to double-weight) their sales factor to compute their California apportionment fraction.[1] We encourage any taxpayer with positive taxable income whose California property and payroll factors are less than their sales factor to file a refund claim. Refund claims for the 2007 year will be due soon for calendar-year taxpayers that filed on extension: California's four-year statute of limitations expires on the fourth anniversary of when the original return was *filed* on extension.

Your refund claim simply needs to raise the issue to the effect that your company is entitled to compute its apportionment fraction following the method provided by the Multistate Tax Compact. Specifically, the refund claim should state that your company is entitled to compute its apportionment fraction using the equally weighted sales factor as provided for under the compact, without regard to any provisions of California law that purport to deviate from the compact. The claim needs to be submitted to:

Refund Unit
Franchise Tax Board
P.O. Box 942857
Sacramento, CA 94257-0540

Discussion

In *Gillette*, the court held that corporate taxpayers are entitled to elect to apportion income under the method set forth in the Multistate Tax Compact. The compact permits interstate taxpayers to apportion income to California based on an equally weighted, three-factor apportionment formula, with the sales factor determined based on costs-of-performance.

This is a decision with broad implications potentially affecting many aspects of the California taxing regime. Prior to the *Gillette* decision, the California Legislature attempted to get ahead of the case by repealing compact provisions[2] from the California Revenue and Taxation Code[3], and by limiting taxpayers' ability to file retroactive refund claims based on the *Gillette* decision. This attempt to preemptively circumvent the court's decision (which we believe is invalid) adds another layer of complexity to California's treatment of the compact.

1. Background and Holding

California incorporates the compact into the Revenue and Taxation Code. The compact includes an election to apportion and allocate income using the method set forth in the compact as an alternative to any method otherwise provided by state law.[4] The compact's method is a three-factor formula composed of property, payroll, and sales factors—all equally weighted.[5] Thus, a taxpayer in a compact state may choose either the apportionment formula under the compact or under some other formula provided by state law.

Until 1993, the California Revenue and Taxation Code provided for the same equally weighted three-factor formula as the compact formula. Then in 1993, the California Legislature amended section 25128 and thereby double-weighted the sales factor. The FTB has taken the position that the new statutory language double-weighting the sales factor also eliminated the taxpayer's option to elect the single-weighted formula under the compact.[6]

According to the court, the FTB's interpretation of this language as the Legislature's attempt to bypass the compact had one fatal flaw: it ignored long-standing law regarding multistate compacts. The court held that when a state enters into a compact with another state, the state enters into a contractual obligation, evidenced by all the indicia of a contract. Such an obligation "effectively surrenders a portion of [the state's] sovereignty; the compact governs the relations of the parties with respect to the subject matter of the agreement and is superior to both prior and subsequent law." The only way for a state to be released from this obligation is to withdraw completely from the compact in a manner prescribed by the compact itself. The court stated this is done by repealing legislation that may only be prospective in nature. Thus, short of the drastic measure of withdrawing completely from the compact,[7] California must continue to uphold its contractual bargain by permitting taxpayers to apportion and allocate income under the terms of the compact.

Accordingly, the court held that, under compact law, California must explicitly withdraw from the compact in order to take away an election that is allowed under the compact. Therefore, until California does so, the election allowed under the compact remains a valid choice for taxpayers.

2. Taxpayer choices under *Gillette*

The obvious take-away from Gillette is that taxpayers may elect to apportion income by using an equally weighted three-factor formula. For all years before 2011, therefore, taxpayers may use either a single-weighted or a double-weighted sales factor to compute their apportionment. Moreover, beginning with the 2011 year, as a result of Senate Bill 15 of the extraordinary session of 2009,[8] taxpayers may also elect to apportion income using only their sales factor. Thus, beginning with the 2011 year, taxpayers may elect any one of the following apportionment methods for each year:

- **Default method**. Three-factor, double-weighted sales factor, with cost of performance sourcing for sales other than sales of tangible personal property.[9]

- **Compact method.** Three-factor, single-weighted sales factor, with cost of performance sourcing for sales other than sales of tangible personal property.[10]

- **Sales-only method.** Sales factor only, with market-based sourcing for sales of services and intangibles.[11]

3. *Gillette's* Effect on Gross Receipts and Finnegan

The apportionment method provided by the compact does not provide any special rules for treasury receipts. The compact also provides no special rule for the treatment of throwback. Thus, if a taxpayer elects the compact method, that taxpayer is entitled to include treasury receipts and hedging receipts in the sales factor. A taxpayer that elects the compact method can compute its sales factor without regard to the provisions of section 25120(f)(2) that exclude those treasury and hedging receipts from the definition of "gross receipts," because that exclusion is not provided for under the compact. In addition, if a taxpayer elects the compact method, it can compute its sales factor using the Joyce rule,[12] because the statutory Finnegan rule is not required under the compact.[13]

4. *Gillette's* Effect on Special Industry Formulas

As an alternative to the above methods of apportionment, certain California taxpayers have been required to apportion income based on special industry formulas.[14] For example, taxpayers qualifying as "franchisors" are required to file using special sales factors that require use of a form of market sourcing[15] and mutual fund service providers have special sales factors that require sourcing, based on mutual funds' customers.[16]

Requiring taxpayers to apportion income based on the taxpayer's industry is highly suspect under the *Gillette* decision. In *Gillette*, the court held that the option of using the method of apportionment prescribed in the compact cannot be modified by the states unless the state withdraws from the compact entirely. The compact, which the court stated was entered into by California and other states to ensure uniformity between member states, would be undermined if a state could simply circumvent its provision by regulatory action. In fact, the court stated, "If a state could unilaterally delete this baseline uniformity provision, it would render the binding nature of the compact illusory and contribute to defeating one of its key purposes, namely, to 'promote uniformity or compatibility in significant components of tax systems.'"

Accordingly, because regulatory action would undermine the uniformity provision highlighted in *Gillette*, we believe that the *Gillette* decision does more than merely permit an election to source using the three-factor formula.

Further, any taxpayer that elects the compact method should be able to use that method without regard to any special industry apportionment rules that have been established by the FTB.

5. The California Legislature's Attempt to Preemptively Bypass Gillette is Invalid

After oral arguments in *Gillette*, which took place May 8, 2012, the California Legislature scrambled to negate or mitigate the effects of a taxpayer victory. As such, the Legislature passed Senate Bill 1015, which was quickly signed into law June 27, 2012.

Senate Bill 1015 repeals the compact provisions from the Revenue and Taxation Code. As an additional measure, the Legislature included the "doctrine of elections" in the bill. Under the doctrine of elections, an election affecting the computation of tax must be made on an original, timely filed tax return. Thus, the compact election, the single-sales-factor election, and any other

tax election affecting the computation of tax cannot be made after the fact through an amended return or refund claim. This doctrine, if effective, could prevent taxpayers, including Gillette, from obtaining tax refunds based on retroactive compact elections.

However, despite its best efforts, we believe the Legislature's attempt to preemptively circumvent the *Gillette* decision was invalid because it violates Proposition 26.

Proposition 26 requires any change in a state statute that would result in any taxpayer paying a higher tax to pass by at least two-thirds of all members of both the State Assembly and the State Senate.[17] The California Legislature passed Senate Bill 1015 with a simple majority in both Legislative houses. Although the bill was passed prior to the court's decision in *Gillette*, this timing does not save Senate Bill 1015.

Although the decision in Gillette was issued after Senate Bill 1015 passed, this sequence of events has no bearing on the application of Proposition 26. The fact remains that, under the holding in Gillette, the compact permits taxpayers to elect compact apportionment. Senate Bill 1015 removed this election, thus increasing the proper amount of tax for corporations that have made or will make the compact election. This simple fact invokes Proposition 26, requiring the vote of two-thirds of each Legislative house. Because Senate Bill 1015 was passed by simple majority, it is invalid.

6. What's Next?

The Franchise Tax Board may now request a rehearing within 15 days.[18] If a petition for rehearing is not filed, the Franchise Tax Board has 10 days to file a petition for review with the California Supreme Court.[19] Although the California Supreme Court grants a very small proportion of petitions for review, we believe that the substantial administrative and fiscal impact of the *Gillette* decision increases the likelihood of the California Supreme Court accepting review of this case.

If the California Supreme Court denies review, the Franchise Tax Board can immediately petition for review before the United States Supreme Court because *Gillette* involves a federal question[20] — the law governing multistate compacts.

7. Action Items for Taxpayers

Because of the impact of the *Gillette* decision, we believe that the Franchise Tax Board will file for review by the California Supreme Court and, if review is denied, then to the United States Supreme Court. Thus, although the Court of Appeal decision is a taxpayer victory that gives California taxpayers many filing options, the decision is not final.

Our recommendation to taxpayers does not change as a result of the *Gillette* decision or Senate Bill 1015. We continue to recommend that California taxpayers file refund claims with the Franchise Tax Board using the method of apportionment that is most beneficial for any given tax year.

If you have questions about the Gillette case or California's increasingly complex apportionment regime, please contact the authors of this article, or the Reed Smith lawyer with whom you usually work. For more information on Reed Smith's California tax practice, visit www.reedsmith.con/catax.

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[1] *The Gillette Company & Subs. v. California Franchise Tax Board*, CA. Ct. App., 1st Dist, Dkt. No. A130803; *appeal from* SF Sup. Ct. Dkt. No. CGC-10-495911.

[2] Rev. & Tax. Code § 38006.

[3] All statutory references are to the California Revenue and Taxation Code unless otherwise noted.

[4] Multistate Tax Compact Art. III § 1 ("Any taxpayer subject to an income tax … may elect to apportion and allocate in accordance with Article IV.") *codified at* Cal. Rev. & Tax Code § 38006.

[5] Multistate Tax Compact Art. IV § 9.

[6] Ch. 946, Laws 1993 § 1, amending Cal. Rev. & Tax Code § 25128(a) to provide that "Notwithstanding Section 38006 [i.e., notwithstanding the compact], all business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four…."

[7] California did attempt to withdraw from the compact last month—right before prior the *Gillette* decision. But we believe such attempt to withdraw is invalid under Proposition 26. See Section 5. Ironically, a pro-taxpayer-friendly former member of California's State Board of Equalization unsuccessfully led the charge (with heavy opposition from the Franchise Tax Board) to withdraw California from the compact in 1999, and another pro-taxpayer member of the State Board of Equalization attempted to curtail California's participation in the compact before that in 1996. The reasons for these actions at that time were due to, inter alia, the perceived anti-taxpayer bias of the Multistate Tax Commission and the disproportionate influence of smaller states over the organization. (1996 S.B. 1393 (as amended May 31, 1996); 1999 A.B. 753.)

[8] 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).

[9] 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 and 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.

[10] Cal. Rev. & Tax Code § 38006 (providing the compact method).

[11] 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. Otherwise, a taxpayer may continue to use cost-of-performance sourcing.

[12] Appeal of *Joyce, Inc*., 66-SBE-070, Cal. St. Bd. of Equaliz., Nov. 23, 1996.

[13] *See* Cal . Rev. & Tax Code § 25135(b), *added* by Ch. 17, Laws 2009 (providing a *Finnegan* rule for throw-back purposes).

[14] *See* Cal. Code Regs. § 25137, *et seq*.

[15] Cal. Code Regs. § 25137-3(b)(2).

[16] Cal. Code Regs. § 25137-14(b).

[17] *See* Cal. Constitution Article XIII A, § 3(a).

[18] Cal. Rul. of Ct. § 2.268(b).

[19] Cal. Rul. of Ct. § 8.8500(e)(1).

[20] *See* 28 USC § 1331; *see also Martin v. Hunter's Lessee*, 14 US 304 (1816).