every state would have repealed it. As it stands, the relevance of the Compact is likely to be revisited once all states use only sales to apportion income ...

Gail Cole • Nov. 01, 2016

On October 11, 2016, the Supreme Court of the United States denied Gillette Company, Inc.'s petition for certiorari for Gillette Co. v. Franchise Tax Board. In so doing, it implicitly upheld the determination by the California Supreme Court: Multistate corporations may not elect to use the apportionment formula established in the Multistate Tax Compact to determine their California income tax. Instead, they must use the double-weighted sales factor apportionment formula mandated by the legislature.

It's a significant case. The question at the heart of Gillette Co. v. Franchise Tax Board

number of multistate corporations, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Division of Income Tax Purposes Act (UDITPA) as a model law in 1957. It included an apportionment formula for income tax based on three, equally weighted factors — property, payroll, and sales — that would later be adopted by the Compact.

But few states adopted the UDITPA and there was growing concern among states that the federal government would intervene in interstate tax laws. Multistate businesses, too, were concerned over the lack of clarity over what could trigger economic nexus. Tensions were heighted after the 1959 U.S. Supreme Court ruling in Northwestern States Portland Cement Co. v. Minnesota, which held that net income from exclusively interstate operations of a foreign corporation may be subject to state taxation.

To placate businesses in the aftermath of this decision, Congress enacted the Interstate Income Act of 1959 (Public Law 86-272), which limits a state's ability to impose a corporate income tax on interstate commerce. In addition, the Congressional Committee on the Judiciary's Special Subcommittee on State Taxation of Interstate Commerce undertook an in-depth study on multistate taxation. The Willis Report (1964), as it became known, recommended mandated uniform apportionment rules based on "an equal weighting of where the business's property and payroll was located."

In response to this Congressional intervention in state tax matters, states worked together to promote uniformity in tax administration procedures and created the Multistate Tax Compact, enacted in 1967. With certain exceptions, the Compact deals with any tax that has a multistate impact, including income tax, gross receipts tax, and sales and use tax. It seeks, in part, to avoid duplicative taxation, equitably apportion tax bases, facilitate taxpayer compliance, and promote uniformity or

compatibility in significant components of tax systems. Article IV of the Compact is

Code. There was no question at the time as to which apportionment policy took precedence — California's or the MTC's — because they were the same.

However, in 1993, the legislature amended the state policy, adopting an apportionment provision with double-weighted sales "notwithstanding" the Compact's provisions (Rev. & Tax. Code,1 § 25128, subd. (a) (section 25128(a)). Although the new apportionment was at odds with the MTC formula, California did not officially withdraw from the Compact at that time. The California Legislature eventually did repeal the Compact in 2012, and California is now an associate member of the Multistate Tax Compact rather than a full Compact member.

The California Legislature then again changed its apportionment provision. Effective for taxable years beginning on or after January 1, 2011, most all trades or businesses may "elect to use a sales only formula to apportion its business income subject to the franchise or income tax in California" (FTB).

When the legislature adopted the new apportionment provision in 1993, FTB attorneys understood it to affirmatively repeal the election of apportioning income under the UDITPA/MTC formula. However, they also acknowledged that a taxpayer could challenge that assumption. What is surprising is that it took so long for a challenge to arise.

The case

In 2010, Gillette and its subsidiaries filed for a refund of approximately $34 million in taxes, based on their election to use the Compact's apportionment formula to compute their California apportionable income tax beginning with their 2006 returns. The California Franchise Tax Board (FTB) denied these refund claims, and in 2010, the taxpayers took the FTB to court. The taxpayers argued they were entitled to the refund based on their election to compute their California apportionable income

using the Compact's three-factor apportionment formula (property, payroll, and

business income shall be apportioned to this state" using the double-weighted sales factor apportionment formula.

The trial court decided in July 2012 in favor of the state, holding that an election was not available. The Court of Appeals then reversed the trial court's decision, determining that multistate taxpayers could elect to use the Compact's apportionment formula. It ruled that, although the states might want the compact to be flexible and nonbinding, it isn't: the Multistate Tax Compact is a binding agreement that "obligates member states to offer its multistate taxpayers the option of using either the Compact's three-factor formula to apportion and allocate state income tax purposes, or the state's own alternative apportionment formula." The opinion is clear on the matter: "This is one of the Compact's key mandatory provisions designed to secure a baseline level of uniformity in state income tax systems."

The state Franchise Tax Board then appealed to the California Supreme Court, which reversed the Appeals Court's decision on December 31, 2015, holding that "an election was not available as a matter of law" (Ct. App. 1/4 A 130803). The opinion states, "In light of the statute's language and this legislative history, there is no credible argument that the Legislature intended to retain the Compact's election provision." Therefore, the Compact is not a binding contract among its members, and California is not required to allow the Compact's election provision. As a result, taxpayers such as Gillette may not elect to use the Compact's three-factor formula to apportion and allocate state income tax.

Gillette then petitioned the U.S. Supreme Court for review; and on October 11, 2016, the United States Supreme Court denied the petition (Docket No. 15-1442).

Ramifications

With the Gillette decision, California no longer needs to be concerned that a ruling

While the original Compact provided for an equally-weighted, three-factor apportionment formula, the amended version recommends a double-weighted sales factor but allows states to define their own factor weighting fraction (Art. IV.9).

There's more at stake here than income tax refunds. Cases similar to Gillette Co. v. Franchise Tax Board are currently making their way through the courts in numerous Compact member states, including Michigan, Minnesota, Oregon and Texas. Not for the first time, the relevance of the Compact and the Multistate Tax Commission has been called into question. Can a non-binding compact still encourage the uniformity the Compact initially sought to create?

The experience with the Multistate Tax Compact has informed the formation of later multistate agreements, notably the Streamlined Sales and Use Tax Agreement. Sections 1101 and 1102 of the SSUTA were included specifically to avoid a similar situation:

Section 1101: COOPERATING SOVEREIGNS

This Agreement is among individual cooperating sovereigns in furtherance of their governmental functions. The Agreement provides a mechanism among the member states to establish and maintain a cooperative, simplified system for the application and administration of sales and use taxes under the duly adopted law of each member state.

Section 1102: RELATIONSHIP TO STATE LAW

No provision of the Agreement in whole or part invalidates or amends any provision of the law of a member state. Adoption of the Agreement by a member state does not amend or modify any law of the state. Implementation of any condition of the Agreement in a member state, whether adopted before, at, or after membership of a state, must be by the action of the member state. All member states remain subject to Article VIII.

Had Gillette won the case, the decision would have been monumental. If the court

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