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Allocation/Apportionment

Following the surprising California Court of Appeal decision in Gillette Co. v. Franchise Tax Board, taxpayers in Multistate Tax Compact member states may press for the long-denied right to elect to use the equally weighted three-factor apportionment formula. On July 24, 2012, the court held that the Multistate Tax Compact, to which California was a signatory, is a binding, multistate agreement that obligates its member states to offer their multistate taxpayers the option of using either the compact's three-factor formula to apportion income, or the state's own alternative apportionment formula.

Repercussions of *Gillette v. FTB*: Will Taxpayers in Other MTC Member States Seek Right to Apportionment Election?

BY ERIN MCMANUS

In a decision that surprised many state tax professionals, the California Court of Appeal held in *Gillette Co. v. Franchise Tax Board*,[1] that the legislature could not ''override and eliminate'' the Multistate Tax Compact section that allowed taxpayers to elect to allocate and apportion their multistate income in accordance with the compact or in a manner provided by the state.

The decision comes after several years of movement by California, along with several other compact member states, away from the uniformity originally intended in the formation of the compact.

''People had forgotten that the compact was created as a critical, binding agreement among states to stave off the federal government's imposition of uniform state apportionment rules after *Northwestern Cement Co. v. Minn.*, 358 U.S. 450 (1959) and the subsequent Willis Report. If the FTB can ignore the MTC compact, how does this impact the binding nature of other non-tax compacts which are so prevalent throughout the United States?'' Michael Herbert,[2] a tax partner in PricewaterhouseCoopers' State and Local Tax practice in San Francisco, told Bloomberg BNA.

Article IV of the compact, the Uniform Division of Income for Tax Purposes Act (UDITPA), provides for a uniform method of apportioning multistate income in Section 9. Under art. IV, §9 business income is apportioned to a state by multiplying the income by a fraction the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three.

The compact does not prohibit member states from adopting an alternative method of apportionment. However compact art. III, §1 allows a taxpayer to ''elect to apportion and allocate his income in the manner provided by the laws of such States or by the laws of such States and subdivisions without reference to this compact, or [to] elect to apportion and allocate in accordance with Article IV.''

The compact was adopted by California under Cal. Rev. & Tax Code (RTC) §38006. Former RTC §25128 also reflected the compact art. IV, §9 formula. However, in 1993, the California legislature amended RTC §25128 to require, ''[n]otwithstanding [§] 38006'' the use of a double-weighted sales factor for most business activities.[3]

Herbert noted:

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[1] *Gillette Co. v. Cal. Franch. Tax Bd.*, No. A130803 (Cal. Ct. App. July 24, 2012).

[2] Mr. Herbert assisted in filing the claims at issue before the California court, helped develop the issue for litigation, and worked with counsel Silverstein & Pomerantz on the case.

[3] 1993 S.B. 1196 (Ch. 946).

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> California never acknowledged or informed taxpayers of the equally weighted apportionment election, although other elections found within the compact were permitted. For example, prior to 1993, California allowed an election to override its statutory provisions for the sale of a non-business partnership interest. On the other hand, the state never made taxpayers aware of the equally weighted apportionment election on any form or combined report instructions.

In reaching its decision in *Gillette*, the court found that, as a member state to the compact, California could not unilaterally repeal compact terms, and that compact art. III, §1 ''specifically extended. . .to taxpayers as third parties regulated under the compact'' the right to elect to apportion their taxes under UDITPA and ''enforce this right as part of [a] tax refund suit.''

The *Gillette* court ruled that the article III ''election provision is not optional for party states.'' Despite Multistate Tax Commission references to the compact as a ''model law'' and ''not truly a compact,'' the court held that the compact is binding on California. The court stated that ''the Compact operates as a model law for those states that choose to be associate members, rather than signatory members.''

Steve Wlodychak, a principal at Ernst & Young in Washington, D.C. told Bloomberg BNA: ''The court got it right. It was a very well thought out, well reasoned decision.'' Thomas Steele, a partner at Morrison & Foerster LLP in San Francisco told Bloomberg BNA, ''the court showed courage and discipline.''

THE FUTURE OF APPORTIONMENT IN CALIFORNIA

Possible Appeal to California Supreme Court

Both Herbert and Steve Danowitz, a partner in Ernst & Young's Los Angeles office told Bloomberg BNA that the FTB was likely to appeal.

In regard to the possible outcome of an appeal, Herbert noted that:

> the court ruled against the FTB on three grounds and the FTB will have to overcome all of them. First, the compact is a binding agreement among sovereign signatory states that California cannot unilaterally alter or amend. Second, the state cannot impair contracts under either the state or federal constitution. Third, the purported change runs afoul of the California constitution's reenactment rule, which is intended to prevent implied repeal of sections.

Herbert also observed that ''the federal impairment ruling gives taxpayers a viable basis to take this to the U.S. Supreme Court, if needed.''

Danowitz also told Bloomberg BNA that ''pending appeal, the FTB likely would not issue any refunds for claims based on the equally weighted apportionment formula until the appeals process was exhausted.'' Nevertheless, he noted: ''Taxpayers that can benefit from the use of equal weighting should consider filing refund claims.''

Validity of S.B. 1015 Under California Proposition 26 The release of the *Gillette* opinion was preceded by the California legislature's passage of S.B. 1015, which was signed into law by Gov. Jerry Brown (D) on June 27 and provided for the withdrawal of California from the compact effective upon enactment.

Although the then pending *Gillette* case was not mentioned in the legislation, Danowitz told Bloomberg BNA that ''there was speculation that oral arguments had not gone well for the FTB, which may have prompted the legislation.''

Despite the legislature's attempt to prevent taxpayer's from making an art. III, §1 election going forward, Wlodychak told Bloomberg BNA ''S.B. 1015 might not be valid under California Proposition 26, which requires a two-thirds vote in both houses of the legislature to approve any law that results in any taxpayer paying a higher tax.''

According to Danowitz, ''the general tax community is aware of Proposition 26 and has noted that S.B. 1015 did not receive the requisite two-thirds vote in either the Senate or Assembly.''

EFFECT OF *GILLETTE* ON OTHER MEMBER STATES Prior to its withdrawal from the compact on June 27,[4] California was one of several compact member states that had amended their apportionment provisions to require taxpayers to use a formula different from the compact's equally-weighted three-factor formula. Many of these amendments were made notwithstanding, with amendment to, or repeal of compact article III, §1.

Although *Gillette* has no precedential value in other state's jurisdictions, it may prove persuasive for taxpayers challenging a member state's mandatory apportionment formula that differs from the compact's equally weighted three factor formula. As Steele told Bloomberg BNA ''*Gillette* shifts the calculus in favor of taxpayers around the country.''

Compact members are states that have enacted the compact into their state law.[5] Following California's withdrawal, the remaining 19 compact member states are as follows: Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington.[6]

Alabama: Alabama adopted the compact in 1997.[7] In 2011, Alabama enacted H.B. 434, which amended art. IV, §9 to require a double-weighted sales factor, retroactively effective for taxable years beginning after Dec. 31, 2010.[8]

Bruce Ely, a partner at Bradley Arant Boult Cummings LLP in Birmingham, Ala. told Bloomberg BNA that ''although the Alabama legislature chose to amend

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[4] The Multistate Tax Commission no longer lists California as a member state on its website at http://www.mtc.gov/AboutStateMap.aspx. Instead, it's now listed as an associate member.

[5] http://www.mtc.gov/About.aspx?id=1818.

[6] http://www.mtc.gov/AboutStateMap.aspx.

[7] Ala. Code §40-27-1.

[8] H.B. 434 also amended art. IV, §17 to replace costs of performance sourcing with market-based sourcing of sales of other than tangible property.

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the state's version of the Compact by editing the Compact itself, in contrast to California, leaving the taxpayer option untouched, the Alabama Department of Revenue may be faced with the same dilemma soon—wait for a test case and fight it out in our courts or convince the legislature, ala California, to withdraw from the Compact.''

Alaska: Alaska adopted the compact in 1970 as Alaska Stat. §43.19.010 and uses art. IV, §9 as its apportionment formula for most businesses.[9]

Arkansas: Arkansas adopted the compact in 1967 as Ark. Code Ann. §26-5-101. In addition, Arkansas enacted UDITPA as Ark. Code Ann. §§26-51-701 through 26-51-721. In 1995, Arkansas enacted S.B. 532, which amended both Ark. Code Ann. §26-5-101, art. IV, §9 and Ark. Code Ann. §26-51-709 to require a double-weighted sales factor.

Colorado: Colorado adopted the compact in 1963 as Colo. Rev. Stat. §24-60-1301. Colorado also enacted, for tax years beginning on or after Jan. 1, 1979, the equally-weighted three-factor apportionment formula in Colo. Rev. Stat. §39-22-303(1), which referenced Colo. Rev. Stat. §24-60-1301.

In 2008, Colorado enacted H.B. 1380, which repealed art. III, §1 from the compact under Colo. Rev Stat. §24-60-1301. H.B. 1380 also repealed Colo. Rev. Stat. §39-22-303(1) and replaced it with Colo. Rev. Stat. §39-22-303.5, which requires taxpayers to use a single-sales factor apportionment formula, effective for tax years beginning on or after Jan. 1, 2009.

Steele told Bloomberg BNA ''the *Gillette* decision might provide Colorado taxpayers with the right to use the three factor election.''

District of Columbia: The District of Columbia adopted the compact in 1981,[10] and separately enacted the equally-weighted three-factor apportionment formula as D.C. Code Ann. §47-1810.02(d).

In 2011, Act 19-21 added D.C. Code Ann. §47-1810.02(d-1), which requires a double-weighted sales factor for tax years beginning after Dec. 31, 2010.

Hawaii: Hawaii enacted UDITPA provisions in 1967,[11] and subsequently adopted the compact in 1968.[12] Both provisions continue to conform to the compact's equally-weighted three-factor formula.[13]

Idaho: Idaho adopted the compact in 1967,[14] and separately enacted UDITPA provisions in Idaho Code Ann. §63-3027. Section 63-3027(i) originally provided for an equally-weighted three-factor apportionment formula.

However, in 1994 H.B. 897 amended Idaho Code Ann. §63-3027(i) by adding paragraph (1) to provide that ''notwithstanding the election in article III, §1 of the multistate tax compact,'' all business income must be apportioned using a double-weighted sales factor.[15]

H.B. 897 also added paragraph (2) to §63-3027(i) to retain the equally-weighted three-factor formula for combined groups.

Kansas: Kansas enacted UDITPA provisions with some modifications in 1963,[16] and adopted the compact in 1967.[17] Kan. Stat. Ann. §79-3279(b) allows a taxpayer to elect to use an equally-weighted three-factor formula or to use a two-factor sales and property formula.

Michigan: Michigan adopted the compact in 1970 as Mich. Comp. Laws §205.581. The single business tax (SBT) originally used the compact's three-factor apportionment formula.[18]

Michigan moved from an equally weighted three-factor formula to a 40 percent weighted sales factor tax years beginning after Dec. 31, 1990. The state enacted a 50 percent or double-weighted sales factor for tax years beginning after Dec. 31, 1992, an 80 percent weighted sales factor for tax years beginning after Dec. 31, 1996, a 90 percent weighted sales factor for tax years beginning after Dec. 31, 1998, a 92.5 percent weighted sales factor for tax years beginning after Dec. 31, 2007, and ultimately a 95 percent weighted sales factor prior to the repeal of the SBT.[19]

The Michigan business tax (MBT) (2008-2011) required and the current (2012 forward) corporate income tax (CIT) require the use of a single-sales factor apportionment formula.[20]

2011 H.B. 4479 amended Mich. Comp. Laws §205.581 to specifically deny the compact art. III, §1 election to CIT taxpayers for all tax years and to MBT taxpayers for tax years beginning on or after Jan. 1, 2011.

Patrick Van Tiflin, a partner at Honigman Miller Schwartz and Cohn LLP in Lansing, Mich. and a member of the Bloomberg BNA State Tax Advisory Board, told Bloomberg BNA: ''No one litigated the initial move away from the equally weighted factor formula. It was towards the end of the SBT with the 90 percent sales factor that taxpayers began to challenge the apportionment formula.''

''Most litigation came later involving the 2008 tax year under the MBT, although we have filed cases under the SBT as well. Treasury disputes that the MBT tax base is subject to the compact because of its combination of net income and gross receipts,'' Van Tiflin told Bloomberg BNA.

Van Tiflin also told Bloomberg BNA, ''the amendment to Michigan's version of compact art. III, §1 was a direct result of such litigation.''

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[9] In 1981, the legislature enacted §43.02.072, which requires oil and gas companies to use a special apportionment formula.

[10] D.C. Code Ann. §47-441. The district adopted the compact with modifications to source sales to the U.S. government to the district by excluding art. III, §2 and modifying art. IV, §16.

[11] Haw. Rev. Stat. §§235-21 through 235-38.

[12] Haw. Rev. Stat. §255-1.

[13] *See* Haw. Rev. Stat. §235.29.

[14] Idaho Code Ann. §63-3701.

[15] The amendment was retroactively effective for tax years beginning on or after Jan. 1, 1994.

[16] Kan. Stat. Ann. §§79-3271 through 79-3288b.

[17] Kan. Stat. Ann. §79-4301.

[18] *See Donovan Constr. Co. v. Mich. Dept. of Treas.*, 337 N.W.2d 297 (Mich. App. 1983), *app. denied*, 419 Mich. 894 (1984).

[19] Former Mich. Comp. Laws §§208.45, 208.45a.

[20] Mich. Comp. Laws §§206.663(3) (CIT), 208.1301(1) (MBT).

Minnesota: Minnesota adopted the compact in 1983.[21]

Dale Busacker, Director of State and Local Taxes at Grant Thornton LLP in Minneapolis, Minn., told Bloomberg BNA:

Prior to 1987, Minnesota had allowed corporate taxpayers the ability to choose to use either the equally weighted three factor apportionment formula or to use an apportionment formula that weighted sales at 70 percent and property and payroll at 15 percent each. In 1987, the legislature decided that taxpayers should no longer have the option to use the equally weighted three factor apportionment formula, and repealed the election provided under Minnesota law and to also repeal the election provided under article III of the compact along with the provisions of article IV.

1999 H.B. 2420 amended the formula to provide for a 75 percent weighted sales factor, and 2005 H.B. 138 required the phase-in of a single-sales factor for 2007 through 2014.[22]

Missouri: Missouri adopted the compact in 1967.[23] Missouri allows taxpayers to elect to use the compact apportionment formula or to use a single-sales factor formula.[24]

Montana: Montana adopted the compact in 2001.[25] Montana also provides for an equally-weighted three-factor apportionment formula under Mont. Code Ann. §15-31-305.

New Mexico: New Mexico adopted the compact in 1967.[26] The state also enacted UDITPA as N.M. Stat. Ann. §§7-4-1 through 7-4-21.

N.M. Stat. Ann. §7-4-3 states that income is to be allocated and apportioned according to UDITPA unless otherwise provided. N.M. Stat. Ann. §7-4-10(A) provides for an equally-weighted three-factor formula, and N.M. Stat. Ann. §7-4-10(B) allows manufacturers to elect to use a double-weighted sales factor, effective for tax years beginning on or after Jan. 1, 2020.

North Dakota: North Dakota enacted UDITPA provisions in 1965,[27] and the compact in 1969.[28] N.D. Cent. Code §57-38.1-21 reflects the equally-weighted three-factor formula in compact art. IV, §9.

Oregon: In 1965 Oregon enacted UDITPA provisions as Or. Rev. Stat. §§305.605 through 305.675, and adopted the compact in 1967.[29] Or. Rev. Stat. §305.605(2) states that the UDITPA provisions ''shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it.''

Or. Rev. Stat. §314.650 originally provided for an equally-weighted three-factor formula. This section was amended in 1989 by H.B. 2643 to require a double-weighted sales factor, effective for tax years beginning on or after Jan. 1, 1991.

2001 H.B. 2281 required the use of a formula with a sales factor weighted 80 percent and the property and payroll factors each weighted 10 percent, effective for tax years beginning on or after May 1, 2003.

2003 H.B. 3183 further amended Or. Rev. Stat. §314.650, effective for tax years beginning on or after July 1, 2006, to require a sales factor weighted 90 percent, and the property and payroll factors each weighted 5 percent. However, 2005 S.B. 31, enacted Sept. 2, 2005, deleted the 90/5/5 formula before it took effect and required a single sales factor, retroactively effective for tax years beginning on or after July 1, 2005.

South Dakota: South Dakota adopted the compact in 1976[30] but does not have a corporate net income tax.

Texas: Texas adopted the compact in 1981.[31] However, the current and prior franchise tax regimes require the use of a single gross receipts factor for the apportionment of income.[32]

David Cowling, a partner at Jones Day in Dallas, Texas told Bloomberg BNA, ''When asked whether the UDITPA three factor apportionment is available in Texas, the Texas Comptroller of Public Accounts has consistently and emphatically said no.''[33]

''Interestingly, as of June, 2012, no Texas taxpayer had appealed an adverse decision on this issue to District Court,'' Cowling said.

Cowling believes, ''the *Gillette* decision will reinvigorate taxpayers who seek UDITPA three factor apportionment in Texas, and lead to an increase in refund claims.''

Utah: Utah adopted the compact in 1969.[34] The state also enacted UDITPA provisions as Utah Code Ann. §§59-7-302 through 59-7-321.

Most taxpayers may elect to use an equally-weighted three-factor formula or a double-weighted sales factor.[35] However, for taxable years that begin on or after Jan. 1, 2013, ''sales factor weighted taxpayers'' must apportion Utah income using a single-sales factor formula to be phased in beginning with tax years beginning on or after Jan. 1, 2011, and ending before Jan. 1, 2013.[36]

A ''sales factor weighted taxpayer'' is defined as having greater than 50 percent of its total sales everywhere generated from other than mining, manufacturing, transportation and warehousing, most information services, or finance and insurance.[37]

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[21] Minn. Stat. §290.171.
[22] Minn. Stat. §290.171(2)(b).
[23] Mo. Laws §32.200.
[24] Mo. Laws §§143.451, 143.461. *See* Mo. Dept. of Rev., Schedule MO-MS Instructions.
[25] Mont. Code Ann. §15-1-601.
[26] N.M. Stat. Ann. §7-5-1.
[27] N.D. Cent. Code §§57-38.1-01 through 57-38.1-21.
[28] N.D. Cent. Code §57-59-01.
[29] Or. Rev. Stat. §305.655.
[30] S.D. Codified Laws §10-54-1.
[31] Tex. Tax Code §141.001.
[32] Tex. Tax Code §171.106(a).
[33] *See, e.g.*, Tex. Comp. of Pub. Accts., Comptroller Dec., Hearing No. 104,752 (Aug. 18, 2011) (notwithstanding absence of repealed statutory prohibition, applicable Texas authorities preclude a taxable entity from electing to use the MTC three-factor formula).
[34] Utah Code Ann. §59-1-801.
[35] Utah Code Ann. §59-7-311(2).
[36] Utah Code Ann. §59-7-311(3).
[37] Utah Code Ann. §59-7-302(2)(a)

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Washington: Washington adopted the compact in 1967.[38] Washington does not have a corporate net income tax. The business and occupations tax is levied on gross receipts for the privilege of engaging in business in the state.[39] Gross receipts are apportioned pursuant to Wash. Rev. Code §82.04.462.

[38] Wash. Rev. Code §82.56.010.

[39] Wash. Rev. Code §82.04.220.

Multistate Tax Compact Member	Multistate Tax Compact Adoption	Separate UDITPA or Other Apportionment Provisions	Equally Weighted 3 Factor Election Allowed
Alabama	1997 as Ala. Code §40–27–1	N/A	No
Alaska	1970 as Alaska Stat. §43.19.010	N/A	N/A
Arkansas	1967 as Ark. Code Ann. §26-5-101	Ark. Code Ann. §§26-51-701 to -721	No
Colorado	1963 as Colo. Rev. Stat. §24-60-1301	Colo. Rev. Stat. §39-22-1301	No
DC	1981 as D.C. Code Ann. §47-441	D.C. Code Ann. §47-1810.02(d-1)	No
Hawaii	1968 as Haw. Rev. Stat. §255-1	Haw. Rev. Stat. §§235-21 to -38	N/A
Idaho	1967 as Idaho Code Ann. §63-3701	Idaho Code Ann. §§63-3027	No
Kansas	1967 as Kan. Stat. Ann. §79-4301	Kan. Stat. Ann. §§79-3271 to -3288b	Yes
Michigan	1970 as Mich. Comp. Laws §205.581	Mich. Comp. Laws §206.663(3)	No
Minnesota	1983 as Minn. Stat. §290.171	Minn. Stat. §290.171(2)(b)	No
Missouri	1967 as Mo. Laws §32.200	Mo. Laws §143.451	Yes
Montana	2001 as Mont. Code Ann. §15-1-601	Mont. Code Ann. §15-1-601	N/A
New Mexico	1967 as N.M. Stat. Ann. §7-5-1	N.M. Stat. Ann. §§7-4-1 to -21	Yes
North Dakota	1969 as N.D. Cent. Code §57-59-01	N.D. Cent. Code §§57-38.1-01 to -21	N/A
Oregon	1967 as Or. Rev. Stat. §305.655	Or. Rev. Stat. §§305.605 to -.675	N/A
South Dakota	1976 as S.D. Codified Laws §10-54-1	N/A	N/A
Texas	1981 as Tex. Tax Code §141.001	Tex. Tax Code §171.106(a)	No
Utah	1969 as Utah Code Ann. §59-1-801	Utah Code Ann. §§59-7-302 to -321	Depends on business activity
Washington	1967 as Wash. Rev. Code §82.56.010	Wash. Rev. Code §82.04.220	No

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