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The MTC Election Following *Gillette vs. Franchise Tax Board*

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Agenda

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Background: The Multistate Tax Compact

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- After the California Court of Appeal decision in Gillette v. California Franchise Tax Board ("*Gillette*"), significant attention has been brought to potential opportunities related to the Multistate Tax Compact ("MTC") for taxpayers both in and outside of California.
- The MTC came into existence in 1967 and now has nearly 20 full member states. The MTC was created to promote uniformity in the manner that state income taxes are levied by providing taxpayers with an election to apportion and allocate income pursuant to the MTC regime instead of a particular state's regime.
- Full members of the MTC sign the compact with terms that require the state to adopt UDITPA.
- UDITPA provides that a taxpayer is permitted to annually elect to apportion income using the apportionment rules of UDITPA in lieu of other apportionment rules adopted by the states.
  - The election only applies to net income taxes
  - The election does not apply to financial corporations or utilities

Background: The Multistate Tax Compact (cont.)

States' Deviations from MTC

- More than half of the states that are full members of the MTC have enacted apportionment formulas that differ from the UDITPA's equal-weighted formula. States typically increase the sales factor weighting, which is generally disadvantageous to taxpayers that have less property and payroll within a particular state, relative to sales in that state.
- In most (but not all) instances, states deviating from the MTC regime have concurrently enacted legislation that attempts to limit or repeal provisions of UDITPA. For example, at issue in Gillette was California Rev. & Tax. Code ("CRTC") Sec. 25128(a), which imposed a double-weighted sales factor apportionment formula "notwithstanding" the MTC regime as adopted by California.
- Key provisions of UDITPA that may be different than typical state rules:
  - Equally weighted three factor apportionment formula; no super weighted sales factor
  - Cost-of-performance for sales of non-TPP; no market sourcing
  - Traditional business v. nonbusiness income definition

Gillette vs. Franchise Tax Board

Gillette vs. Franchise Tax Board

Gillette Background

- In *Gillette*, various taxpayers filed refund claims based on the position that California's adoption of the MTC allowed them to elect to use the MTC apportionment rules, which contained an equally-weighted three-factor apportionment formula.
- The FTB denied these refund claims, arguing that the "notwithstanding" language of California's standard apportionment regime (contained in CRTC Sec. 25128), either superseded or repealed the MTC, and thus required the use of California's standard apportionment formula, which contained a double-weighted sales factor.

Gillette vs. Franchise Tax Board (cont.)

Legislative Preemption Attempt

On June 27, 2012, the California legislature, passed Senate Bill 1015 ("SB 1015"), which:

- Attempted to repeal the MTC in California
- Legislatively declared the following:
  - "(a)The doctrine of election (see generally Pacific Nat. Co. v. Welch (1938) 304 U.S. 191), provides 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.
  - (b) The doctrine of election described in subdivision (a) applies to any election that affects the computation of tax under [Division 2, Parts 10, 10.2, and 11 of the CRTC]..."

Gillette vs. Franchise Tax Board (cont.)

Gillette Opinion(s)

July 24, 2012 — California Court of Appeal held for the taxpayers, and determined that:

- The MTC is a valid enforceable interstate compact.
- Although a compact can be repealed, because interstate compacts are binding contractual agreements between sovereign states, the compact cannot be unilaterally altered or amended.
- Absent a full repeal, the MTC superseded prior and subsequent statues, including CRTC Sec. 25128.

August 9, 2012 — The Court of Appeal ordered a rehearing in Gillette, which had the effect of vacating its prior decision.

Gillette vs. Franchise Tax Board (cont.)

October 2, 2012 — California Court of Appeal reissued its decision which was substantially the same, except:

- The discussion of the MTC underwent a tense change to reflect that the MTC was in force during the years at issue, but that the state had attempted to repeal it with the passage of SB 1015 on June 27, 2012.
- The court clarified that CRTC Sec. 25128 was an unconstitutional violation of U.S. Const., art. I, § 10, cl. 1., which prohibits states from passing any law impairing the obligation of contracts.

Gillette vs. Franchise Tax Board (cont.)

The FTB's Response to *Gillette*

- October 5, 2012 — The FTB Released Notice 2012-01, addressing protective refund claim procedures, providing that the FTB will treat such a claim "as a request that the… Board take no action on the claim currently, but rather that the claim is filed to avoid the bar of refunds by the statute of limitations."
- October 5, 2012 — An FTB News Flash announced that the FTB believes taxpayers making the MTC election on a timely filed original return for 2011 will run the risk of triggering the large corporate underpayment penalty if Gillette is subsequently vacated, reversed, or overturned.
  - News Flash's perspective on "change of law" debatable
- FTB is expected to seek California and U.S. Supreme Court review in Gillette

Gillette vs. Franchise Tax Board (cont.)

California Considerations Post-*Gillette*

Prop. 26 may render SB 1015 invalid in whole or in part. According to Prop. 26:

*"Any change in state statute which results in **any taxpayer paying a higher tax** must be imposed by an act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature…"*

MTC repeal **may** be challenged under Prop. 26.

- SB 1015's "Doctrine of Election" declaration **may** to be challenged
- FTB's failure to raise the doctrine of election in *Gillette* before SB 1015 enacted calls into question applicability of doctrine
- *Pacific Nat.* Co. may be limited in scope
- If Doctrine exists, questionable application to MTC election
- If Doctrine as described was not existing law, may violate Prop. 26

Gillette vs. Franchise Tax Board (cont.)

California Considerations Post-*Gillette* (cont.)

- Taxpayers who may benefit from using an equally-weighted apportionment formula (or applying other MTC apportionment rules) in California should consider filing protective refund claims in anticipation of the ultimate resolution of the MTC matter.
  - Could trigger an overall audit
- Similarly, taxpayers should consider whether making the MTC election on original returns may be appropriate because the validity and/or operative date of the MTC repeal may be in question, and the original return requirement may be more likely to hold up prospectively.
  - Possible penalties should be considered (in particular the large corporate underpayment penalty)

Gillette vs. Franchise Tax Board (cont.)

California Considerations Post-*Gillette* (cont.)

Taxpayers electing to use the MTC apportionment regime are not simply applying the MTC's formula; rather they are electing to apply all of the MTC's allocation and apportionment rules. For example, the MTC election may have implications in areas such as:

- Nonbusiness income allocation
- Sales factor sourcing
- Gross receipts definition
- Industry-specific rules

Potential Implications in Certain Other MTC States

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Potential implications in those other states that are members of the Compact and have enacted the provisions of the MTC into their respective state laws.

- The California Court of Appeal in Gillette refuted, as a violation of the Contract Clause of the U.S. Constitution, the attempt by California to enact statutory constraints on the terms of the MTC. While the court cited other bases for its holding, the U.S. Constitutional logic has potential significance beyond California.
- The court's directive that an MTC member state must formally withdraw from the Compact in order to give effect to statutory apportionment formulas that deviate from the MTC terms may be applicable in certain other states that are currently members of the MTC. Note that only those member states that have enacted the Compact into their state law and that have enacted statutory apportionment deviations from the original MTC provisions are potentially affected.
- If the holding in Gillette were adopted in other states that had joined the MTC and had modified the apportionment provisions contained in the Compact without withdrawing from the Compact, the ability to elect the MTC's three-factor (single-weighted sales factor) apportionment provisions may potentially be available in such other states.

Potential Implications in Certain Other MTC States (cont.)

Relevance of Original Gillette Decision to Other Member States

- The MTC election only applies to taxes on or measured by net income. It may have no bearing on the position of states like Texas, with respect to the Margins Tax, and Michigan, with respect to the Modified Gross Receipts Tax portion of the Michigan Business Tax, which may not be considered net income taxes for this purpose.
- Although other state courts may find the holding in Gillette persuasive, a decision of the California Court of Appeal (or of the California Supreme Court on appeal) is not precedential authority in other states. While it may be unlikely, the decision could be upheld strictly on the contract clause of the California constitution.
- The likelihood of a lengthy appeal itself may also limit the willingness of a state court to place undue weight on the logic and holding in the Gillette Court of Appeals decision.

Potential Implications in Certain Other MTC States (cont.)

While not raised by the FTB in the Gillette case, other states may take the position that the MTC election must be made on an original return, in an attempt to prevent taxpayers from making the MTC election on an amended return. Consideration should be given to the Missouri Supreme Court decision (Bartlett v. Director of Revenue, State of Missouri, 1983), in which the Missouri court held that the apportionment election made by the taxpayer on its original return could not be subsequently changed by taxpayer.

Potential Implications in Certain Other MTC States (cont.)

- Oregon — On September 24, 2012, a Department Corporation Tax Policy Coordinator issued a release:
  - Noting that there was ongoing litigation in Oregon based on arguments similar to those raised in Gillette,
  - Stating that it is the Department's position that the MTC 3-Factor Election "is not available on an Oregon return," and
  - Providing a recommended procedure for filing protective refund claims
- Texas — State's position is that the Texas Margins Tax ("TMT") is not an income tax eligible for the MTC election
  - State statute says that the TMT is not an income tax
  - The issue is subject to some debate based on definition of net income tax in UDITPA but the state has a strong position

Potential Implications in Certain Other MTC States (cont.)

Considerations Upon Filing a Refund Claim

- Taxpayers may want to consider options to protect their interests pending resolution of the MTC issue in relevant states — e.g., potentially filing protective refund claims based on the MTC election.
- As noted for California, a valid MTC election potentially adopts all of the MTC's allocation and apportionment rules.
- As with any potential refund claim, the decision to file a protective refund claim should consider all relevant facts and circumstances.
  - Audit risk?
  - Tolling of statute of limitations?
  - Penalties? — frivolous return? — substantial understatement?

Potential Implications in Certain Other MTC States (cont.)

MTC States Potentially Impacted by *Gillette*

- Alabama
- Arkansas
- California
- Colorado
- The District of Columbia
- Idaho
- Michigan
- Minnesota
- Oregon
- Texas
- Utah

IBM vs. Michigan Department of Treasury

IBM vs. Michigan Department of Treasury

- On November 20, 2012, the Michigan Court of Appeals held for the Michigan Department of Treasury, and determined that:
- The MBT Act and the Compact were in “irreconcilable conflict” and could not be harmonized
  - Court made no discussion or analysis of the history of the MTC and the relevance of why a state would seek to incorporate UDITPA into state law
- As a result of this conflict, the Court held that the later-enacted MBT Act “repealed by implication” the Compact
- The Michigan Court stated that the MTC is a not a truly binding contract because the words “contract” or “covenant” do not exist in the Compact
  - As a result, the enactment of a 100%-weighted sales factor apportionment formula that conflicts with UDITPA is not impermissible

IBM vs. Michigan Department of Treasury

- Michigan Court of Appeals did not reach the issue of whether the Modified Gross Receipts element of the MBT is an “income tax” for UDITPA purposes
- The IBM Court of Appeals’ decision is an unpublished decision.
  - Persuasive but not binding on another Michigan court.
  - Treasury could file a motion with Court of Appeals to have decision “published.” A published decision would be binding.
- The taxpayer in IBM is likely to seek review by the Michigan Supreme Court
- Similar cases are moving forward in the Michigan Court of Claims

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