

## tax lawflash

October 11, 2012

## California Tax Refund Opportunity Based on *Gillette*

*Taxpayers should review their apportionment methodology for prior taxable years to determine whether they should file refund claims based on the Multistate Tax Compact's evenly weighted three-factor apportionment formula.*

On October 2, in *Gillette Co. v. Franchise Tax Board*,<sup>1</sup> the California Court of Appeal reaffirmed upon rehearing that provisions of the Multistate Tax Compact (MTC or Compact) were binding and enforceable by taxpayers seeking to rely upon the MTC's evenly weighted three-factor apportionment formula in support of refund claims for previous taxable years. The Court of Appeal further held that California's 1993 statutory amendment providing for a double-weighted sales factor was ineffective in repealing or replacing the evenly weighted three-factor formula under the Compact with respect to the taxable years at issue. Taxpayers should consider whether they may have potential refund claims by applying provisions of the Compact and, if so, should act now in order to file protective refund claims for the 2008 tax year no later than October 14, 2012, to the extent they have statutes of limitations expiring on such date due to original returns filed on extension.

### Background

The Compact was created to facilitate proper determination of the state and local tax liabilities of multistate taxpayers. California enacted and became a member of the Compact in 1974. Prior to 1993, California allowed multistate taxpayers to apportion their business income to California using the evenly weighted three-factor (property, payroll, and sales) apportionment formula under the Compact's Uniform Division of Income for Tax Purposes Act (UDITPA). In 1993, the California Legislature sought to replace the MTC apportionment formula by enacting a mandatory double-weighted sales-factor formula pursuant to California Revenue and Taxation Code § 25128.

### ***Gillette Co. v. Franchise Tax Board***

In 2010, The Gillette Company and other taxpayers (the Taxpayers) initiated litigation in California courts collectively seeking approximately \$34 million in refunds for prior taxable years based on the Compact's evenly weighted three-factor apportionment formula. The Taxpayers argued that California's enactment of the double-weighted sales-factor apportionment formula did not effectively override or repeal the MTC formula and that the Taxpayers were permitted to elect use of the evenly weighted three-factor formula based on the Compact. The trial court initially dismissed the Taxpayers' suit for refund on the ground that the option to use the MTC apportionment method was no longer available upon the enactment of California Revenue and Taxation Code § 25128. The Taxpayers' cases were consolidated for appeal.

On June 27, 2012, Governor Jerry Brown signed into law Senate Bill No. 1015, which was directly aimed at repealing the Compact along with the MTC apportionment formula provision. Notably, Senate Bill No. 1015 was passed by the California Legislature with less than two-thirds vote in each house. Taxpayer challenges to Senate Bill No. 1015 are expected based on Proposition 26, which requires any revenue-raising legislation to be passed

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1. *Gillette Co. v. Franchise Tax Bd.*, No. A130803 (Cal. Ct. App. Oct. 2, 2012), available at <http://www.courts.ca.gov/opinions/documents/A130803A.PDF>.

by two-thirds of each house of the California Legislature.

On July 24, 2012, the California Court of Appeal issued an opinion concluding that, with respect to the taxable years at issue, the Compact was valid and enforceable, including the evenly weighted three-factor apportionment formula. The court further held that California was bound to the terms of the Compact until such time as California affirmatively enacted legislation withdrawing from the Compact.

On August 9, 2012, the California Court of Appeal formally withdrew and vacated its July 24 *Gillette* opinion and ordered a rehearing. However, on October 2, 2012, upon rehearing, the court reaffirmed its prior opinion while clarifying that (1) California Revenue and Taxation Code § 25128 was an unconstitutional impairment of contract during the tax years at issue to the extent it sought to override and disable California's obligation under the Compact and (2) that California's 2012 repeal of the Compact was not before the court. The Court of Appeal's decision should be final 30 days from the date of filing on November 1, 2012, and then the Franchise Tax Board (FTB) has 10 days to file a petition for discretionary review with the California Supreme Court.

## FTB Guidance

On October 5, 2012, the FTB issued Notice 2012-01 cautioning that the FTB may appeal *Gillette* to the California Supreme Court.<sup>2</sup> The notice states that, even if the FTB fails to obtain a reversal, upon remand to the trial court it will raise other defenses to *Gillette*'s claim for refund, including the issue of whether such an election can be made on an amended return.

On the same day, the FTB issued a *Tax News* article<sup>3</sup> providing that taxpayers electing to use the MTC's evenly weighted three-factor apportionment formula on their original 2011 tax returns potentially may be subject to the 20% large corporate understatement penalty under California Revenue and Taxation Code § 19138 in the event that *Gillette* is ultimately overturned. The article notes that returns on extension are due on October 15, 2012, which is before the date that the Court of Appeal's decision in *Gillette* becomes final.

## Other States

In other states that are members to the Compact, similar controversies are ongoing regarding taxpayers' ability to elect to use the MTC's evenly weighted three-factor apportionment formula. Cases are currently pending before the Michigan Court of Appeals and the Oregon Tax Court.<sup>4</sup> The Oregon Department of Revenue recently issued guidance providing its position that the MTC apportionment formula under the Compact should not be available in Oregon, but that the Department of Revenue will defer action on protective refund claims pending the decision of the Oregon Tax Court.

The Texas Comptroller of Public Accounts recently issued administrative decisions denying Texas margin tax refund claims based on the MTC apportionment formula. See Tex. Comp. Decision Nos. 106,508; 106,723; 107,192. As such, litigation is also likely to be forthcoming in Texas on this issue.

## Potential Refund Claims

Protective refund claims based on the MTC apportionment formula election may be available for taxpayers whose California payroll and property factors are lower than their sales factors (e.g., out-of-state corporations making substantial sales into California). Taxpayers should review their California apportionment methodology for prior taxable years to determine whether they should pursue filing protective refund claims within the statutes of

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2. FTB Notice 2012-01 is available at [https://www.ftb.ca.gov/law/notices/2012/2012\\_01.pdf](https://www.ftb.ca.gov/law/notices/2012/2012_01.pdf).

3. Franchise Tax Board, "Flash—Large Corporation Underpayment Penalty Guidance," *Tax News* (Oct. 5, 2012), [https://www.ftb.ca.gov/professionals/tax\\_news\\_flash/2012/100512.shtml](https://www.ftb.ca.gov/professionals/tax_news_flash/2012/100512.shtml).

4. *Int'l Bus. Machs Corp. v. Dep't of Treasury*, No. 306618 (Mich. Ct. App. filed Oct. 12, 2011); *Health Net, Inc. & Subs. v. Dep't of Rev.*, No. 120649D (Or. T.C. filed July 2, 2012).

limitations for prior tax years. Due to California's 20% large corporate understatement penalty, we **do not recommend** that taxpayers elect to use the MTC apportionment formula on original 2011 returns, but rather, consider whether filing protective refund claims may be appropriate.

In addition, taxpayers should review whether they may have refund claims available in other states that are members of the MTC. In addition to the MTC apportionment formula election, potential refund claims may be available based on other differences between the Compact's provisions and state statutes (e.g., definition of business income, sales-factor sourcing provisions, throw-out and throw-back sales-factor rules, and add-back requirements).

Taxpayers should continue to monitor the ongoing litigation in California and other states regarding the election to use the MTC apportionment formula. Any taxpayers with potential refund claims should act quickly since many state statutes of limitations for returns filed on extension require refund claims to be filed no later than October 14, 2012.

## Contacts

If you have any questions concerning the issues discussed in this LawFlash, or need assistance in reviewing whether to file refund claims, please contact any of the following Morgan Lewis attorneys:

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