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California Court of Appeal issues opinion in Gillette rehearing

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In brief

The California Court of Appeal, without further oral argument, filed its opinion on rehearing in the matter of *Gillette v. Franchise Tax Board*, finding that the Multistate Tax Compact is a valid compact and California was bound by it and the Article III apportionment election provision throughout the years in question because the state had not repealed former Sec. 38001, et. seq., and withdrawn from the Compact during the tax years at issue. (Op. on Rehearing, Oct. 2, 2012) The Court's opinion on rehearing is substantially similar to its original opinion, with a few notable exceptions. [Click here](#) for our summary of the original opinion.

In detail

In its August 8, 2012 Petition for Rehearing, the FTB asserted that the Court's decision did not determine whether amended Section 25128 is unconstitutional and therefore invalid because it prohibits the Compact election. The petition contended that "[w]ithout further explanation of the Court's reasoning, it is not clear where the Court has determined that the 1993 amendment to section 25128 is being declared unconstitutional or whether the court has reconciled the provisions of amended section 25128 with those of section 38006...[b]ecause the decision does not explicitly hold that amended section 25128 is unconstitutional, the statute remains on the books and must be enforced by the FTB..."



In its opinion on rehearing, the Court addressed this issue and unambiguously declared Section 25128 unconstitutional to the extent it attempted to remove from California law the equally-weighted three factor apportionment election afforded to taxpayers under the Multistate Tax Compact. Recall that in 1993, the California legislature amended Section 25128 to state that, "notwithstanding" the Compact, all business income shall be apportioned using a double-weighted sales factor. The Court found that "[S]ection 25128, by its plain terms, sought to override and disable California's obligation under the Compact to afford taxpayers the option of apportioning income under the UDITPA formula. To this extent, and during the tax years at issue, section 25128 was unconstitutional, as violative of the prohibition against impairing contracts."

The Court also took note of the enactment of S.B. 1015 on June 27, 2012, repealing all references to the Multistate Tax Compact from California law (a summary may be [found here](#)). The opinion states that "[S]enate Bill No. 1015, and any issue concerning its effect or validity, were not before this court." Many practitioners believe that a challenge to SB 1015 under Proposition 26 is likely. Under Proposition 26, any revenue-raising bills must be passed by a 2/3 vote in each house of the legislature. Since SB 1015 will increase the tax liability of certain taxpayers and it was passed with less than a 2/3 vote in each house, many practitioners question its authority.

Michael Herbert, PwC Tax Partner in San Francisco, who assisted in filing the claims in *Gillette*, notes that this decision involves more than a tax question. At stake is the broader issue of multistate compacts and the rights of the member states to adopt practices impacting a compact's provisions. There are over 200 compacts in use in the United States today, covering a broad array of topics including agriculture, elections, environment, children, parks, and public safety. (The Compacts in use can be found here- <http://apps.csg.org/ncic/>.) The *Gillette* court was careful to consider the binding force of compacts, both from a constitutional and statutory perspective. This well reasoned determination should withstand further challenge on appeal, including any procedural questions that may be brought by the state.

From an historical perspective, one must not forget the very reason the Multistate Tax Compact was created. Its formation was in response to the *Northwestern States Portland Cement* decision permitting state taxation of interstate operations and the congressional activity that followed in its wake. First, Congress enacted Public Law 86-272. It then authorized a study for the purpose of recommending legislation establishing national uniform standards over the taxation of interstate businesses. The Multistate Tax Compact was drafted in recognition that traditional state tax activity was disjointed and inefficient, as well as out of concern of federal intervention in state taxation. Enactment of the Multistate Tax Compact successfully prevented federal intervention and created a mechanism ensuring uniformity in state tax systems. Compact member states should merit these bedrock principles of the Multistate Tax Compact.

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