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Gillette Overturned: One Test, Two Decisions in California

On Thursday, December 31, 2015, the Supreme Court of California issued its decision in *Gillette Co. v. Franchise Tax Board*.[1] The court reversed the California Court of Appeal and held that the Multistate Tax Compact is not a binding compact between its member states. Accordingly, the California legislature had the authority to, and did in fact, replace the state's equally weighted apportionment formula with a double-weighted-sales formula in 1993.

Despite following an identical test to determine whether an interstate compact is a binding reciprocal agreement, the California Court of Appeal and Supreme Court of California clearly saw the case very differently. Both courts used the analytical framework provided by the U.S. Supreme Court in *Northeast Bancorp v. Board of Governors FRS* to analyze the binding nature of the Compact but reached opposite conclusions. In particular, the supreme court found that the Compact satisfies none of the three "classic indicia" of binding interstate agreements under *Northeast Bancorp*: (1) state enactments that require reciprocal action for their effectiveness; (2) conditional consent by member states in which each state is not free to modify or repeal its participation unilaterally; and (3) the presence of a joint organization for regulatory purposes. This is in stark contrast to the prior court of appeal opinion, which concluded that the Compact had these three indicia and, therefore, was a binding agreement.

Reciprocal Obligations?

Citing *Northeast Bancorp*, the California Supreme Court found that the creation of reciprocal obligations between member states is the single "most important factor" in determining the existence of a multistate compact. The court found that the election provision in Article III of the Compact (which allows a taxpayer to elect between the equally weighted three-factor formula and another formula adopted by a state) did not create any reciprocal obligations between member states:

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1 *Gillette Co. v. Franchise Tax Bd.*, No. S206587 (Cal. Dec. 31, 2015).

> The Compact's provision of election between the UDITPA or any other state formula does not create an obligation of member states *to each other*. Even if maintenance of the election provision in one member state might benefit taxpayers in another state, that benefit to the taxpayer applies whether the taxpayer is from a member or nonmember state.

On the other hand, the court of appeal expressly found that this election provision supported the conclusion that the Compact "builds in binding reciprocal obligations that advance uniformity."[2]

Interestingly, the California Supreme Court did not address the court of appeal's finding that Article V of the Compact further creates reciprocal obligations between party states because it (1) obligates each member state to provide a full credit to taxpayers who previously paid sales or use tax in another state; and (2) requires party states to honor sales and use tax exemption certificates from other states. The court of appeal held that these sales and use tax credit provisions were "mandatory on signatory states."

Conditional or Unilateral Action?

The California Supreme Court also found that the Compact did not bear the second of the three indicia of a binding multistate compact—that its effectiveness depends on the conduct of other members or its provisions prohibit unilateral action. Instead, the court found that the action of no other state was required to permit California to join the Compact, and under the Compact states are unilaterally free to "come and go as they please." According to the court, this unilateral ability "militates against a finding that the Compact is a binding interstate agreement."

This holding is again inconsistent with the court of appeal decision, which agreed with the taxpayer and concluded that unilateral withdrawal did not weigh against the second factor. Recall that the court of appeal flatly rejected the FTB's argument (relying on *Northeast Bancorp*) that the Compact was not a binding agreement (at least with respect to the elective apportionment at issue) because a true binding agreement would not permit unilateral withdrawal. The court of appeal disagreed with the FTB, holding that "this type of withdrawal provision is common in other interstate compacts and has not been the death knell rendering them nonbinding and invalid." Moreover, the court of appeal distinguished *Northeast Bancorp* on its facts because the compact in question in that case "could be changed as well as repealed at will."

Nevertheless, the California Supreme Court placed great reliance on the fact that the Multistate Tax Commission (MTC) has recognized that a state may modify the apportionment formula and remain in good standing under the Compact. The court thus held that "the freedom of members to engage in such unilateral conduct [amending apportionment formulae and joining and leaving the Compact at will] is inconsistent with the type of binding agreement contemplated by *Northeast Bancorp*."

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[2] *Gillette Co. v. Franchise Tax Bd.*, 207 Cal. App. 4th 1369, 1384 (2012).

Joint Regulatory Body?

The California Court of Appeal found the existence of the MTC indicative of a binding compact, describing the MTC as "an operational body charged with duties and powers in furtherance of the Compact's purposes." The court of appeal noted that the MTC is "composed of tax administrators from all member states, and is financed through a process of allocation and apportionment."

By contrast, the California Supreme Court viewed the MTC quite differently, liberally citing to *U.S. Steel Corp. v. Multistate Tax Commission* for support in concluding that the MTC was nonregulatory in nature. The court held that, whatever the role and powers of the MTC, it has "no authority ordinarily associated with a *regulatory* organization"; rather, according to the court, the MTC performs "an advisory and informational role" only, recommending proposals and assisting states in implementation of the Compact. States are free to disregard the MTC's advice or amend its regulations. In addition, the MTC may perform audits on behalf of member states only if authorized by a state, and the MTC—like any other hired auditor—must use the state's courts to compel compliance with an audit.

The decision thus does not seem to take issue with the MTC's multistate audit function even though the MTC is not functioning as a true regulatory organization. The court notes in this regard:

> In such a case, the Commission acts as "the State's auditing agent" and any power of compulsory process derives from the authority vested by the laws of the requesting member state. (*U.S. Steel, supra,* 434 U.S. at p. 457; Compact, art. VIII, § 4.) Further, although the Commission may "require the attendance of persons and the production of documents in connection with its audits," it "has no power to punish failures to comply" and "must resort to the courts for compulsory process, as would any auditing agent employed by the individual States." (*U.S. Steel*, at p. 475; Compact, art. VIII, §§ 3-4.)

Because the court found the Compact to be nonbinding, it concluded that it did not need to decide whether the Compact "takes precedence over other state law"; i.e., Section 25128, which contains the purportedly mandatory double-weighted sales factor formula. The court also held (1) that the "reenactment" rule of the California Constitution did not invalidate the 1993 legislation amending Section 25128 to impose the mandatory double-weighted formula; and (2) that the California legislature unambiguously intended to amend the apportionment formula.

In a footnote, the court addressed the taxpayer's argument that the U.S. Supreme Court would have invalidated the Compact in *U.S. Steel* if it had any doubts about its validity (i.e., by finding that the Compact was not invalid, the Court implicitly agreed that the Compact was binding). However, the court concluded that such "argument is unpersuasive." In particular, the court interpreted *U.S. Steel* as having concluded only that the compact clause of the U.S. Constitution "did not require Congress to approve the Compact for it to be valid.… The court had no occasion to decide whether the Compact constituted a binding agreement that could not be unilaterally amended by its members. Indeed, *U.S. Steel* predated *Northeast Bancorp*, wherein the high court first articulated the factors to consider in determining the binding nature of an interstate agreement." It is clear that the Supreme Court of California gave significant deference to the MTC's

characterization (in its amicus brief) of the Compact, its role as administrator of the Compact and its lack of control over Compact member states' actions in connection with the Compact.

Counsel for the taxpayer has already indicated that it will request certiorari with the U.S. Supreme Court, but it is far from a certainty that the Court will agree to take the case. It remains to be seen whether a state split will emerge from the various pending cases throughout the country. A taxpayer win in Michigan or Oregon could help entice the Court, but each case is somewhat unique and may not result in a "true" split.

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