State and Local Tax ADVISORY

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California Voters Approve Proposition 39, but Significant Questions Remain Regarding How Corporate Taxpayers Can Apportion Their Income

This past Election Day, California voters approved Proposition 39, a ballot initiative that requires corporations conducting a multistate business to apportion their income using a single-sales factor apportionment formula. In 2009, California enacted single-sales factor apportionment as an elective alternative to double-weighted three-factor apportionment for tax years beginning on or after January 1, 2011. However, under Proposition 39, the single-sales factor method will be mandatory for most corporations beginning January 1, 2013.[1] Proposition 39, which received 60 percent of the vote, is expected to generate $1 billion annually, with the revenue from the first five years dedicated to energy efficiency projects and education.

Critics of the measure assert that it will negatively impact out-of-state corporations doing business in California by raising taxes, since most such corporations apportion using the weighted three-factor formula. On the other hand, proponents of the measure characterized it as one that would close a "loophole" and argue that it will encourage businesses to locate in California, thus leading to the creation of new jobs.[2]

The approval of Proposition 39 comes on the heels of another significant California apportionment development in the landmark California Court of Appeal decision, *Gillette Co. v. Franchise Tax Bd.*, No. A130803 (Cal. Ct. App., July 24, 2012), *aff'd on reh'g*, No. A130803 (Cal. Ct. App., October 2, 2012). In that case, Gillette contended that it had the option to apportion its income using either the three-factor formula contained in the Multistate Tax Compact (the "Compact"), of which California is a member, or the double-weighted three-factor formula provided in Section 25128 of the Revenue and Taxation Code (this option is referred to as the "Compact Election"). That section purported to deny taxpayers the ability to apportion under the Compact, thereby eliminating the Compact Election. The California Court of Appeal agreed with Gillette, holding that California was prohibited by compact law, the express terms of the

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[1] A business that derives more than 50 percent of its gross business receipts from an agricultural business activity, an extractive business activity, a savings and loan activity, or a banking or financial business activity is exempt from the single-sales factor apportionment requirement, and is instead required to use an equally weighted three-factor formula. *See* Cal. Rev. & Tax. Code § 25128(b), (c).

[2] Certainly, the application of a single-sales factor apportionment formula will by design favor in-state companies that have significant property and payroll in the state, but that make significant sales out of state, as is the case with any state's enactment of a similar method. Its effect on job creation, however, remains to be seen. Moreover, California's current elective single-sales factor apportionment regime is the reflection of an affirmative tax policy decision, not a "loophole," notwithstanding the fact that the elective regime resulted in less revenue for the state.

Compact itself and the Contracts Clause of the Constitution from repealing or modifying individual portions of the Compact. Rather, in order to eliminate the Compact Election, California was required to repeal (i.e., withdraw from) the Compact in its entirety, as provided for in the Compact itself. Since California had not done this, the court concluded that Gillette could make the Compact Election and apportion its income under the three-factor equally-weighted apportionment formula. The Franchise Tax Board has announced that it will appeal this decision to the California Supreme Court.

Accordingly, under *Gillette*, a corporate taxpayer may elect to apportion its income under either the Compact's three-factor formula or any alternative formula permitted by California law (including the new single-sales factor provision enacted by Proposition 39). However, on June 27, 2012, while *Gillette* was still pending, the California State Assembly enacted SB 1015. That bill purports to (a) repeal the Compact in its entirety, and (b) provides that a taxpayer would have to make the Compact Election on its original, timely filed return in order to use the three-factor formula according to the so-called "doctrine of elections" (i.e., it could not file a refund claim using the Compact formula). As a result, SB 1015 would deprive taxpayers of any prospective benefit that could otherwise be gained from the *Gillette* holding.

However, there are significant questions regarding the validity of SB 1015 and whether the repeal of the Compact was effective. SB 1015 was not approved by a two-thirds majority of the Assembly, as is required of "[a]ny change in state statute which results in any taxpayer paying a higher tax" under Proposition 26 (Section 3 of Article XIIIA of the California Constitution). Assuming *Gillette* stands, then the repeal of the Compact would result in at least one taxpayer paying a higher tax, by depriving all taxpayers of the Compact Election. If the legislation is struck down, the Compact would still be in effect in California and, based on *Gillette*, taxpayers could elect to apportion their income using either the three-factor Compact formula or the single-sales factor formula mandated by Proposition 39. (Note that if taxpayers utilize the Compact formula, they would also need to apply all of the other provisions of Article IV of the Compact, including the costs of performance method for sourcing sales of services and intangibles; by contrast, the single-sales factor formula applies a market-based sourcing rule for sales of services and intangibles. As a result, out-of-state taxpayers may realize significant benefits from using the Compact formula, rather than the new single-sales factor formula.)

In sum, although Proposition 39 was approved by a majority of California voters, it is highly unclear whether the single-sales factor apportionment formula it requires will become the exclusive method of apportioning income for multistate corporations doing business in California. Taxpayers should stay tuned for further developments.

Please contact Ethan Millar, the partner-in-charge of our California State and Local Tax Group, or any other member of our State and Local Tax Group, to discuss the *Gillette* decision, SB 1015, Proposition 39 and how these authorities may impact your business.

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