



2012 COST ANNUAL MEETING

Orlando, Florida

MTC Apportionment – Yes, No, Maybe?

The National Ramifications of the Gillette Case, Recent Legislation and Cases Pending in Other States

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Learning Objectives

Understand the MTC 3-factor election

Discern if there is an opportunity for your company to use the election

Recognize the actions that need to be taken to preserve the benefit

Analyze the current litigation surrounding the election

Preliminary Poll

Have you heard of the Multistate Tax Commission, the Multistate Tax Compact or the availability to elect an alternate apportionment factor under the Multistate Tax Compact?

A) Yes

B) No



Preliminary Poll

Have you ever made an election on behalf of your company to use an alternate apportionment factor under the Multistate Tax Compact in a member state?

A) Yes

B) No



History of Multistate Tax Compact

In 1959, The United States Supreme Court opened the door for states to tax interstate commerce with its decision in *Northwest Portland Cement v. State of Minnesota* (1959) 358 U.S. 450.

In response, Congress enacted P.L. 86-272, which specified that the mere presence of salesmen in a state for the purpose of soliciting sales of tangible personal property does not constitute sufficient nexus to confer upon that state jurisdiction to impose a net income tax on the seller.

P.L. 86-272 also commissioned a special Congressional subcommittee to study multistate taxation. The study produced recommendations to restrict the state's jurisdiction to tax and to create a federal sales tax system.

In response to the Commission's recommendations and threat of federal legislation, various state organizations met to consider a cooperative response.



Creation of Multistate Tax Compact

The state representatives understood that individual opposition to the pending legislation would not be successful in preempting federal action.

Their cooperative effort to prove to Congress that the states themselves were capable of solving this problem culminated in the creation of an interstate compact known as the Multistate Tax Compact (“MTC”).

“The Multistate Tax Compact makes UDITPA available to each taxpayer on an optional basis, thereby preserving for him the substantial advantages with which lack of uniformity provides him in some states The Multistate Tax Compact thus preserves the right of the states to make such alternative formulas available to taxpayers even though it makes uniformity available to taxpayers where and when desired.” (Third Annual Report Multistate Tax Commission)



Multistate Tax Compact Election

“Thus a corporation which is selling into a state in which it has little property or payroll will want to insist upon the use of the three-factor formula (sales, property and payroll) which is included in UDITPA because that will substantially reduce his tax liability to that state below what it would be if a single sales factor formula were applied to him; on the other hand, he will look with favor upon the application of the single sales factor formula to him by a state from which he is selling into other states, since that will reduce his tax liability to that state.”

(Third Annual Report Multistate Tax Commission).



Advantages of Using UDITPA Formula

MTC Brochure to Businesses at the Time of Enactment

“Advantages To Businesses:

Choice of Uniform Division of Income Act or state income tax allocation systems . . .

Businesses required to pay income tax in more than one state or subdivision can choose between the allocation methods of the Uniform Division of Income Act or those of the state or subdivision.”



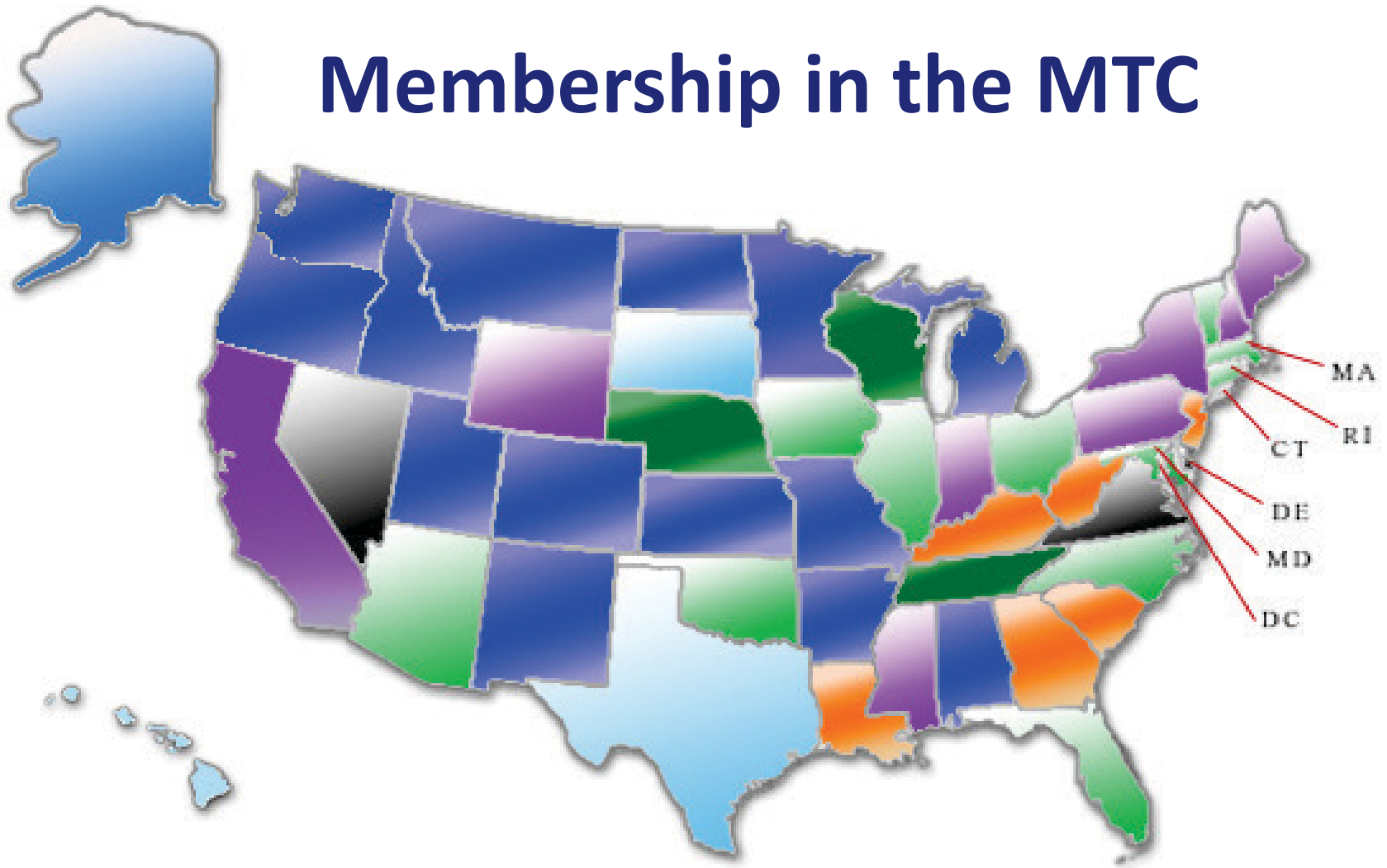
Enactment of Multistate Tax Compact

The Effective Date of the MTC was, under its terms, August 4, 1967, the date on which the seventh state enacted the MTC into law.

By June 30, 1968, a total of 13 states had enacted the MTC into law.

By June 30, 1970, a total of 20 states had enacted the MTC into law.

Membership in the MTC



Blue = Compact Member

Orange = Sovereignty Members

Purple and Green = Associate and Project Members



Different MTC Membership Levels

Full Member State

- Has adopted the Compact into law. Pays membership dues and has full voting rights in the MTC and its various committees. Receives special contracted program services at cost.

Sovereignty Member State

- Pays membership dues and receives special contracted program services at cost, but has not adopted the Compact and, thus, cannot vote in MTC proceedings. Can participate and vote in various committees, such as uniformity, and can participate or lead task forces.

Associate or Project Member State

- Participates in MTC special contracted programs and committees. Has no vote. Pays the cost of the special contracted programs in which it participates, plus a 15% surcharge for administrative costs.



Challenges to Multistate Tax Compact

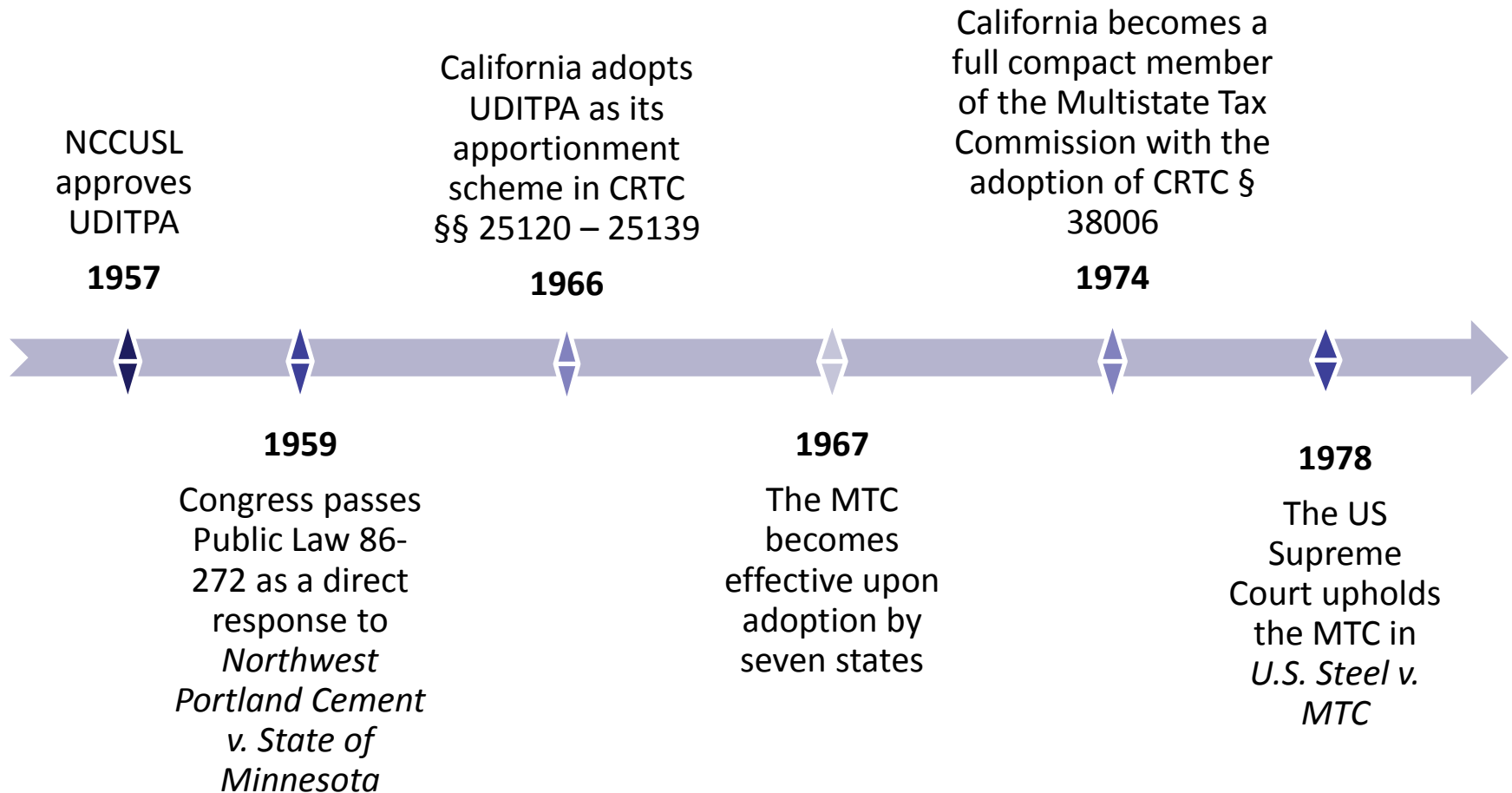
***U.S. Steel Corporation v. MTC* (1978) 434 U.S. 452**

1978 - A class of multistate corporate taxpayers brought suit to set aside the MTC as a violation of the United States Constitution.

The Court determined that the MTC was constitutional because it was not "directed to the formation of any combination tending to the increase of political power in the States, which may encroach upon or interfere with the just supremacy of the United States..." (*Id.*)



California Timeline





California Timeline

CA Adopts
“Hyper
Weighted” /
Four Factor
Formula

1993

CA AG Opines – MTC
Membership Dues
Mandatory until
withdrawal from
Compact

1997

Gillette Files Suit
after denial of
Refund Claims by
FTB

January 2010

1995-96

Budget Control
Language
Conditioning CA
MTC Membership
on MTC adopting
Open Meetings Act

2006

Gillette Files
Amended Returns
/ Claims for
Refund for TY
1997 – 2004
Claiming 3-Factor

October 26, 2010

Trial Court
sustains FTB
Demurrer in
Gillette



California Timeline

May 8, 2012

Oral Arguments in Ct. Appeal in Gillette

July 24, 2012

Court of Appeal Reverses Trial Court in Gillette

??



SB 1015

Repealing Multistate Tax Compact approved by majority vote, signed into law by Governor

June 27, 2012

October 2, 2012

Court of Appeal Issues Opinion on Rehearing and Reverses Trial Court in Gillette



California Revenue & Taxation Code Sections

§ 38006 (The Multistate Tax Compact)

- **Article III, (1):** “Any taxpayer . . . whose income is subject to apportionment and allocation . . . pursuant to the laws of a party state . . . **may elect** to apportion and allocate his income in the manner provided by the laws of such State . . . without reference to this compact, or **may elect to apportion and allocate in accordance with Article IV.**”
- **Article IV, (9):** “All business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.”

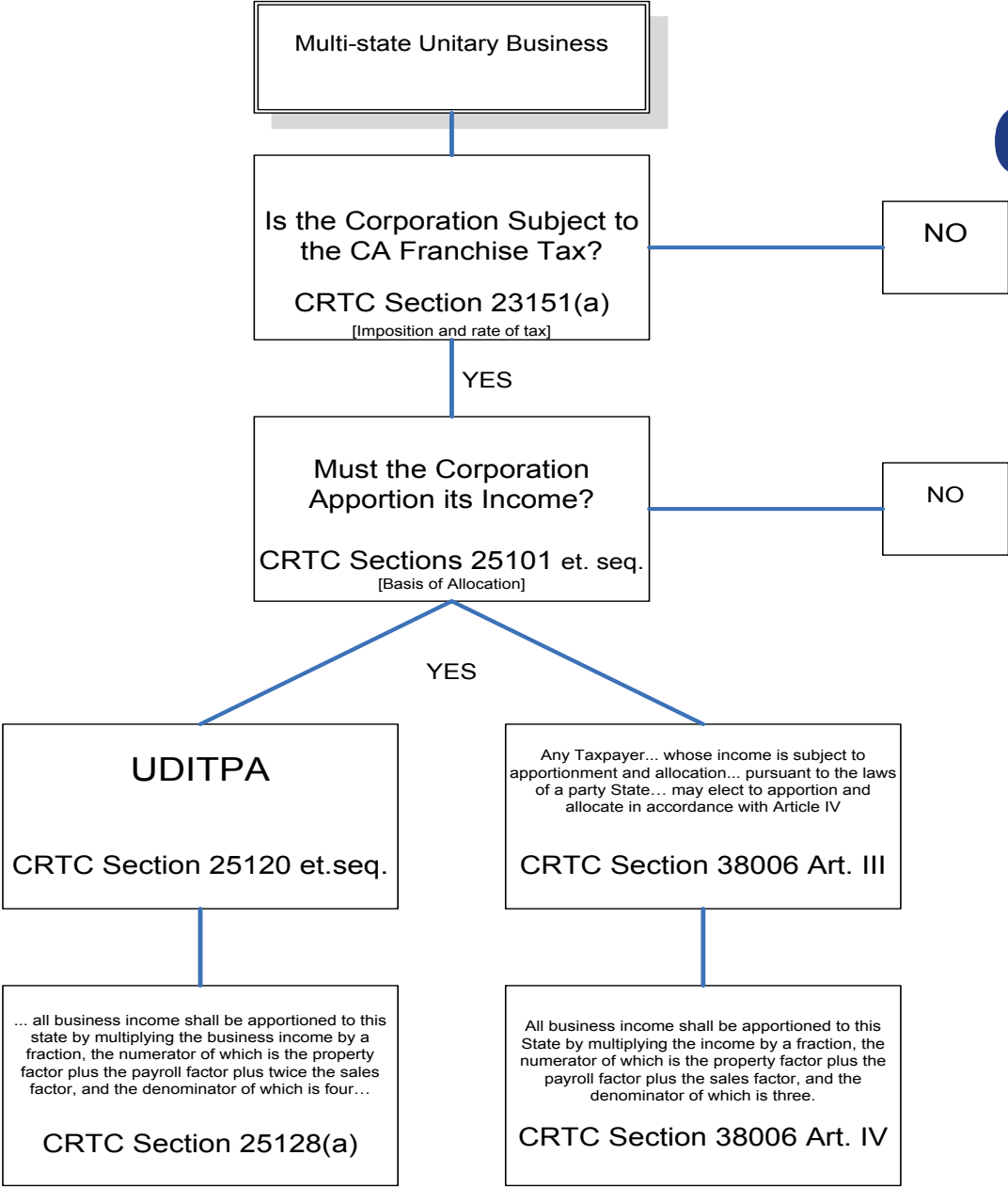


California Revenue & Taxation Code Sections

§ 25128(a) Formula for Apportioning Business Income to California (California's UDITPA)

*“Notwithstanding Section 38006, all business income shall be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus **twice the sales factor**, and the denominator of which is four . . .”*

CRTC §§ 25128 & 38006 Dual Track Methodology



Double Weighted Sales Factor

Single Weighted Sales Factor



CA Attorney General Opinion

1997 80 Ops. Cal. Atty. Gen. 213 (WL 440749):

“The liability of a member state at the time of its withdrawal from the Compact must be based upon the provisions of the Compact, which is a contract among the member states. (Texas v. New Mexico (1987) 482 U.S. 124, 128, see Oklahoma v. New Mexico (1991) 501 U.S. 221, 245 (conc. Opn. of Rehnquist, C.J.).)”

In the *Matter of the Appeal of Peoplesoft (SBE 2004)*

FTB argued *in favor* of the MTC Election (Respondent’s Opening Brief, July 7, 2004).



***Gillette* - Opposing Arguments made by the FTB**

CRTC § 25128 supersedes CRTC § 38006 and requires a taxpayer to apportion its business income using a double weighted sales factor.

The MTC is nothing more than a voluntary association of states, and the document does not expressly prohibit unilateral amendments by a member state's legislature.

The MTC was never ratified by Congress and thus the Compact Clause of the U.S. Constitution does not apply.

Taxpayers do not have standing to bring a breach of contract suit under the terms of the MTC.



Other Interstate Compacts to which California is a Party

California is currently a member of 27 Interstate Compacts

- Agreement on Detainers
- Agreement on Qualifications of Educational Personnel
- California-Nevada Compact for Jurisdiction on Interstate Waters
- Civil Defense and Disaster Compact
- Colorado River Compact
- Colorado River Crime Enforcement Compact
- Compact for Education
- Compact on Placement of Children
- Drivers License Compact
- Interstate Compact on Agricultural Grain Marketing
- Interstate Compact Defining the Boundary b/w AZ and CA
- Southwest Low-Level Radioactive Waste Disposal Compact
- Interstate Compact for Adult Supervision
- Interstate Compact on Licensure of Participants in Horse Racing with Pari-Mutuel Wagering
- Interstate Compact on Juveniles
- Interstate Compact to Conserve Oil and Gas
- Interstate Corrections Compact
- Interstate Pest Control Compact
- Iowa-Nebraska Boundary Compact
- Klamath River Compact
- Multistate Tax Compact
- Pacific Maritime Fisheries Compact
- Tahoe Conservancy Agency Compact
- Tahoe Regional Planning Compact
- Western Corrections Compact
- Western Interstate Nuclear Compact
- Western Regional Education Compact



What Happened in *Gillette*

Oct. 26, 2010 – Trial Court Grants FTB Demurrer

- Statutory Construction of CRTC 25128
“notwithstanding” and “all” key to Legislative Intent
- Compact is non-binding according to *US Steel*.
 - Justice Powell’s Statement concerning the advisory nature of the Compact.

May 8, 2012 – Oral Arguments Before CA Court of Appeal.



SB 1015

June 13, 2012 – SB 1015 Amended:

- Repeals Multistate Tax Compact
- Declares “doctrine of election” as defined applies to elections affecting the computation of tax.
- Appropriates \$1,000 to FTB for Admin Costs
- Declares bill “related to budget bill”
- June 27, 2012 – Approved by Assembly 50-26 / Senate 24-15, signed by Governor.



The SB 1015 Conundrum

Art. XIII A, Sec. 3 (Amended by Prop. 26)

“Any change in state statute which results in *any* taxpayer paying *a* higher tax must be imposed by . . . not less than two-thirds” vote.

Art. IV, Sec. 12 (Added by Prop. 25)

“..the budget bill and *other bills providing for appropriations related to the budget bill*” may be passed by majority vote and take effect immediately.



CA Court of Appeal

July 24, 2012 – Court of Appeal issues its original decision

- “This **binding**, multistate agreement **obligates** member states to offer its multistate taxpayers the option of using either the Compact’s three-factor formula to apportion and allocate income for state income tax purposes, or the state’s own alternative apportionment formula. (§ 38006, art. III, subd. 1.) ***This is one of the Compact’s key mandatory provisions designed to secure a baseline level of uniformity in state income tax systems, a central purpose of the agreement.***”



CA Court of Appeal

- The Compact is a valid, enforceable interstate compact.
- CA cannot unilaterally repeal Compact terms
- Compact supersedes CRTC Section 25128
- FTB construction would violate Impairment of Contracts Clause
- FTB construction runs afoul of Re-enactment Clause.



Vacating its own Decision

Gillette petitions for “clarification”

FTB petitions for rehearing

Court Orders Rehearing on Own Motion.

October 2, 2012 - Opinion on Rehearing issued:

- “Senate Bill No. 1015, and any issue concerning its effect or validity, were not before this court.”
- Section 25128 is an unconstitutional violation of the contracts clause only to the extent it attempts to override the Compact’s election.



California

- **What should a taxpayer do post-*Gillette*?**
 - Consider filing protective claims for refund for prior years
 - FTB Notice 2012-01 (October 5, 2012)
 - Sets forth FTB's guidance as to how to file protective claims
 - Such claims will be held in abeyance pending final resolution in *Gillette*
 - Also sets forth FTB's potential arguments in opposition to the election, including whether the election can be made on an amended return
 - What about 2011 original returns?
 - On October 6, 2012, FTB issued a News Flash indicating that a taxpayer making the election on its 2011 return runs the risk of having the large Corporate Underpayment Penalty ("LCUP") imposed if *Gillette* is ultimately reversed



The MTC 3-factor election in Michigan

- **Michigan is a full compact state and adopted the MTC effective July 1, 1970.**
- **The MTC is contained in Chapter 205 of the Michigan Compiled Law (MCL).**
- **The MTC election is contained in MCL § 205.581, Art. III (1).**
- **MTC 3-factor defined in MCL § 205.581, Art. IV.**



Applying the Election to the Michigan Single Business Tax and Michigan Business Tax

- **Definition of “Tax” at MCL §205.581:**

“Tax” means an income tax, capital stock tax, gross receipts tax, sales tax, use tax, and any other tax which has a multistate impact.”

- **Definition of “Income tax” at MCL §205.581:**

“Income tax” means a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, 1 or more forms of which expenses are not specifically and directly related to particular transactions.”

- MBT was composed of four separate tax levies and a surcharge.



Exception to “Tax”

- **Included in MCL § 205.581: Articles III, IV and V – limits definition to only those taxes specifically designated within the Act.**
- **Article IV – speaks to an income tax and net income.**
- **Also limits use of arbitration.**



Articles III and IV

Under Article III, if subject to an income tax, a taxpayer can either use the state provided apportionment formula or the Article IV (3-factor) formula.

- Short form option based on sales also available.

Under Article IV – net income from business activities qualifies for apportionment under the 3-factor formula.

- No consideration of non-income taxes.
- May impact benefit of election under the Michigan Business Tax.



What was the SBT, What is the MBT?

- SBT was a value added tax (*Trinova*).
- MBT was a combination of a business income tax, a gross receipts tax, a net worth tax (financial institutions), a gross risk insured tax (insurance co's) and a surcharge applied to all these taxes.
 - There exists a severability clause.
 - ASC treatment not necessarily relevant.
- The Corporate Income Tax, effective 1/1/12 is a pure income tax.



Apportionment Methods Under the MBT

- **The single-factor apportionment provision under MCL § 208.1301;**
- **The 3-factor apportionment formula under MCL § 205.581, Section III(1) of the Compact; or**
- **The alternative apportionment provision under MCL § 208.1309.**
 - **Requires advance consent by the Treasurer**



2011 P.A. 40

- **Enacted on 5/25/11, effective 1/1/11**
- **For levies under Chapter 208 (the MBT), requires adherence to MBT apportionment provisions rather than Article IV. Does not expressly repeal the Compact.**
- **Reasonable interpretation is that MTC election is available for MBT years prior to January 1, 2011.**
- **Additionally, further application of MTC election if challenges to the retroactive application of 2011 PA 40, or determination by Court that Compact must be expressly repealed or withdrawn from in order to preclude election.**



Leading Michigan Case – *International Business Machines*

- Election taken on both the Business Income Tax base and the Modified Gross Receipts Tax base.
- Compact is binding contractual election.
- Election applied to former Michigan Corporate Income Tax.
- Michigan law does not favor implied repeal.
- Alternative Apportionment provisions under the MBT do not render the Compact election meaningless.



Order Entered by Court of Claims

- **Ruled that Article III(1) of the Compact was repealed by implication when the Legislature prescribed a specific apportionment methodology that “shall be used” under the MBT.**
- **Concluded that MCL § 208.1309 [alternative apportionment] would be rendered meaningless if the Legislature did not intend to repeal Article III(1) of the Compact.**
- **Did not consider whether the modified gross receipts tax was an income tax.**



Appeal to Court of Appeal

- **Amici Briefs filed by the Multistate Tax Commission and Michigan Manufacturers Association**
- **Oral argument heard on October 3, 2012**
- **Key Questions by 3-judge panel:**
 - **If election is available, why doesn't the alternative apportionment provisions of MCL § 208.1309 not apply?**
 - **If Michigan violates the Compact, could there be repercussions from other states who are members to the Compact?**
 - **The issue of whether or not the Compact was a binding contract under Michigan law *was not* before the court**



Filing of Protective Refund Claims

- Taxpayers should consider filing their 2011 MBT return (extended due date December 31, 2012), making the Compact election, or file an amended return for 2011 MBT returns already filed.
- Consider filing amended returns for MBT years 2008-2010.
- Consideration should also be given to 2012 Corporate Income Tax returns (due April 30, 2013) as Michigan has not expressly repealed the Compact or withdrawn from the Compact.
- Has only prohibited the Election from applying.



Other Latent Issues Involved in MTC Election Cases

- The MBT nexus standards were not supported by US Supreme Court precedent. If the court concludes that the MBT was an income tax, P.L. 86-272 would apply, providing other refund opportunities for out-of-state companies.
- Denial of 3 factor formula based on doctrine of legislative acquiescence, currently disfavored by the Michigan Courts. *Karaczewski v Farbman Stein & Co*, 478 Mich 28 (2008).
 - If such occurs, implications for other cases
- Article IV provides the tax administrator the right to exclude one or more of the factors or to employ any other method to effectuate an equitable apportionment of the taxpayer's income.



Settlement Poll

Have you ever successfully raised an alternative apportionment formula election under the MTC during settlement proceedings in a member state?

A) Yes

B) No



Choice of Forum in Michigan for Denials of Refund Claims

- **Michigan Tax Tribunal – prepayment forum. Primary jurisdiction over property tax matters.**
- **Court of Claims (Ingham County Circuit Court) – requires payment of tax, interest and penalty. Note, payments deposited directly into the general fund.**
- **The current political environment can affect tax refunds, and must be monitored.**



The Compact Election in Other States

Texas

- **Comptroller's Decision Nos. 106,508; 106,723; and 107,192, decided 7/13/12, released 9/12/12**
- **Taxpayer's election to apportion its Texas margin tax using the equally weighted three-factor formula under the Compact was denied**
- **Comptroller held that the taxpayer was required to use a single gross receipts factor apportionment formula**
- **Comptroller relied upon three prior Comptroller decisions—Nos. 104,752, 104,753 and 105,941**
- **Comptroller concluded that the MTC election was not available under Texas law**



The Compact Election in Other States

Oregon

- ***Health Net, Incorporated and Subsidiaries v. Department of Revenue, Case No. 120649D***
 - Pending in Oregon Tax Court
 - Complaint Filed July 2, 2012
 - Taxpayer is asserting that it has the right to apportion its income under the Compact's equally weighted three-factor formula
- **Department of Revenue Guidance**
 - On September 24, 2012, the Department notified taxpayers that similar to the *Gillette* case in California, the MTC apportionment election is currently being challenged in Oregon
 - Department will defer action on all protective claims for refund until the outcome of the *Health Net* litigation is known



Questions?

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