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U.S. Supreme Court Update

U.S. SUPREME COURT UPDATE

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Supreme Court Receives New Petition for Certiorari in Multistate Tax Compact Litigation

***43** In this issue of the JOURNAL, we discuss the recent petition filed in *Gillette v. California Franchise Tax Board* (Docket No. 15-1442), which is the latest development in the protracted litigation involving various states' attemptsto override the Multistate Tax Compact (the 'Compact'), a multistate agreement that addresses the apportionment of income among states for tax purposes. On 5/27/16, Gillette, now a wholly owned subsidiary of Procter & Gamble, along with severalother corporate taxpayers, filed a petition with the U.S. Supreme Court, seeking review of a judgment of the Supreme Court of California.

The petition asks the Court to consider whether 'the Multistate Tax Compact has the status of a contract that binds its signatory States.' The taxpayers allege in their petition that in its ruling below, the California Supreme Court mistakenly foundthat the Compact, 'notwithstanding its contractual language, actually has no binding effect on the signatories.'

We also note that the Court has denied two previously reported petitions. In addition, there is a three-way fight over unclaimed property, wherein a number of states have asked permission to sue each other in the Supreme Court over unclaimed property revenues.The next issue of the JOURNAL will highlight *Delaware v. Pennsylvania and Wisconsin.* The motion for leave to file a Bill of Complaint submitted by the State of Delaware cites to the Court's 'exclusive and original jurisdiction'to hear the suit under Article III, Section 2, Clause 2, of the U.S. Constitution and Title 28, Section 1251 (a) of the U.S. Code.

The Multistate Tax Compact—A Binding Contract That Is Subject to the Constitution's Contract Clause?

In *Gillette v. California Franchise Tax Board*, Docket No. 15-1442, petition for cert. filed 5/27/16, ruling below at 363 P.3d 94 (Cal. 2015), Gillette, along with several other corporate taxpayers, asks the Court to review a decision by the California Supreme Court, in which California's highest court held that the Multistate Tax Compact (the 'Compact')does not qualify as a binding reciprocal agreement. The court also found that the California Legislature possessed both the *authority* and the *intent* to supersede the Compact's apportionment election provision.

****2** The petition for certiorari argues, among other things, that review is warranted because the California Supreme Court erred in its holding that the Compact is not a binding contract and therefore subject to the Constitution's Contract Clause. Having 'heldthat the Compact is not binding, the California Supreme Court declined to decide whether a binding interstate compact that

has not been approved by Congress takes precedence over other state law or whether California's departure from the Compact violates theContract Clause.‘

UDITPA and the promulgation of the Multistate Tax Compact.

In 1957, the National Conference of Commissioners on Uniform State Laws adopted a model statute for dividing income among the states, titled the Uniform Division of Income For Tax Purposes Act (‘UDITPA‘). As the California Supreme Court explained,states were not quick to adopt UPITPA. However, ‘the incentive arose with the specter of federal intervention,‘ as a result of the U.S. Supreme Court's decision in *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450 (1959). In this case, the Court found that in-state solicitation of sales provided sufficient nexus for the state to tax corporate income and that ‘net income from the interstate operations of a foreign corporation may besubjected to state taxation, provided the levy is not discriminatory and is properly apportioned to local activities within the taxing [S]tate.‘

Congress reacted to this decision authorizing a study of the state taxation of multistate businesses to recommend legislation establishing uniform standards. ‘The study, known as the ‘Willis Report,’ recommended a uniform two-factor apportionmentformula based on the amount of property and payroll in each state, as well as a blanket nexus standard that limited income tax jurisdiction to states in which a business had either real property or payroll.‘

Other congressional bills were also introduced proposing, in effect, federal preemption of critical aspects of state taxation. This threat of federal legislation resulted, in 1966, in a group of tax administrators and Attorneys General beginning work ondrafting the Multistate Tax Compact and the adoption of UDITPA by 19 states by 1967.

Apportionment under the Multistate Tax Compact.

As explained by the court below, ‘the Compact includes two central features. The first is the creation of the Multistate Tax Commission (Commission). . . . The second central feature is the adoption of the UDITPA's equal weighted apportionment formula.‘This formula utilizes three factors—(1) a property factor, (2) a payroll factor, and (3) a sales factor—and allows taxpayers to determine their in-state ***44** taxable income by dividing their in-state property, payroll, and sales by the worldwide property,payroll, and sales of the business. These three factors are then added and divided by three, and the resulting percentage is multiplied by the business's worldwide income to determine what amount of its income is subject to tax in a particular state.

****3** According to the California Supreme Court, the Compact also ‘contains an election provision,‘ whereby a taxpayer that is subject to the apportionment of income ‘in two or more party States may elect to apportion and allocate his income in themanner provided by the laws of such State,‘ or, alternatively, elect to rely on the Compact's equally weighted apportionment formula.

In 1974, the California Legislature adopted the Compact and incorporated its apportionment provisions into state law. At the time it adopted the Compact, however, California ‘previously adopted the UDITPA formula,‘ so the Legislature's ‘actionresulted in no immediate apportionment change.‘

California adopts a double-weighted sales factor.

According to the California Supreme Court, ‘[t]his situation changed in 1993 when the Legislature adopted a different apportionment formula.‘ In adopting a new apportionment formula, the California Legislature amended section 25128(a) ofthe state's Tax Code to provide that, ‘[n]otwithstanding . . . [the provisions of the Compact], *all* business income *shall* be apportioned to this state by multiplying the business income by a fraction, the numeratorof which is the property factor plus the payroll factor plus *twice* the sales factor, and the denominator of which is *four.*‘ Under this new formula, in-state sales were double-counted.

As the California Supreme Court notes, ‘the 1993 legislation did not expressly withdraw California as a member state of the Compact, or otherwise modify the Compact's election provision or apportionment formula.‘ Rather, the legislation resultedin the California Franchise Tax Board (‘FTB‘) taking the position that the Legislature could properly preclude a taxpayer from relying on the Compact's election provision and that California's double-weighted statutory formula controls.

Thus, when the taxpayers in the case below sought refunds for the taxes paid under California's new formula, the FTB denied the refund claims. A trial court sustained the FTB's demurrer but, on appeal, a California Court of Appeals reversed, ‘reasoningin part that the Legislature could not unilaterally repudiate mandatory terms of the Compact, which permitted election.‘ The FTB then petitioned the California Supreme Court for review.

California's highest court held that the Compact is not a binding reciprocal agreement.

On review, the California Supreme Court held that the state's Legislature was not bound to allow taxpayers to utilize the Compact's elective apportionment provision. The Court also explained that it ‘need not decide whether an interstate compact notapproved by Congress necessarily takes precedence over other state law. Instead, we evaluate whether this Compact is a binding compact among its members.‘

In reaching its decision, the court noted that the Commission, which is the Compact's governing body, had filed an amicus brief with the court, arguing that the Compact was not binding. As set forth in the court's opinion, ‘[i]n the Commission'sown view, the Compact is not binding. Rather, it is an advisory compact that contains two apportionment provisions, the UDITPA [equally-weighted] formula and the election provision . . . which are more in the nature of model uniform laws.‘

****4** In its brief, the Commission cited to the U.S. Supreme Court's holding in *Northeast Bancorp v. Board of Governors*, 472 U.S. 159 (1985) in support of this interpretation. On appeal, the California Supreme Court looked to *Northeast Bancorp* to determine whether the Compact was binding.

According to the California court, *Northeast Bancorp* listed several ‘indicia of binding interstate compacts,‘ none of which the Compact satisfies. First, the court began with what it referred to as the ‘[m]ost important[]‘factor—i.e., ‘whether the Compact created reciprocal obligations among member states.‘ The court determined that ‘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.*‘ Accordingly, there are no reciprocal obligations among Compact members.

Next, the court reviewed whether the Compact's effectiveness ‘depends on the conduct of other members and whether any provision prohibits unilateral member action.‘ Finding that ‘[n]o action by existing members was required to admitCalifornia‘ to the Compact and that ‘any state may join or leave the Compact without notice,‘ the court reasoned that ‘[t]his ability of member states to unilaterally come and go as they please militates against a finding that theCompact is a binding interstate agreement.‘ Moreover, the court noted that currently, ‘only seven of the Compact's 16 members employ the equally-weighted [apportionment] formula.‘ Thus, again, the court reasoned that ‘[t]hefreedom of members to engage in such unilateral conduct is inconsistent with the type of binding agreement contemplated by *Northeast Bancorp.* ‘ ***46** Finally, the court examined whether the Compact had a binding ‘regulatory organization.‘ Although the taxpayers argued that ‘the establishment of the Commission is ‘a classic characteristic of an interstate compact,’‘ the court disagreed,noting ‘that body has no authority ordinarily associated with a *regulatory* organization.‘ Instead, the court viewed the Commission's powers as ‘strictly limited to an advisory and informational role, ‘ and therefore ruled that ‘theCommission's inability to bind member states to adopt [regulations] further confirms it is not a regulatory organization within the meaning of *Northeast Bancorp.*‘

In their petition for review, the taxpayers take exception with the court's reading of *Northeast Bancorp*, arguing that ‘the lower court elevated the nonexhaustive ‘indicia of binding interstate compacts' stated in *NortheastBancorp* into a ‘test.’‘ According to the taxpayers, the U.S. Supreme Court should grant the petition because ‘[t]he California Supreme Court held that *Northeast*

Bancorp states a novel and singular rule that governsthe construction of interstate agreements and that, under this rule, the Compact is not binding on its signatories. That holding was wrong.‘

The taxpayers further argue in the petition that the California Supreme Court's decision ‘rests on a plain misunderstanding of *Northeast Bancorp*; it wholly disregards the broader body of this Court's decisions addressing the applicationof interstate agreements; and, as a consequence of these errors, it misconstrues the [Compact] in a manner that benefits domestic state tax authorities at the expense of out-of-state taxpayers.‘

**5 More generally, the taxpayers also argue as one of the reasons for granting the petition that the California Supreme Court's decision ‘adopts a bizarre approach to the interpretation of interstate compacts generally, jeopardizing critical agreementsbetween States that currently are embodied in many dozen of similar compacts.‘ As such, the taxpayer's contend that the Court ‘should review and set aside [the *Northeast Bancorp*] holding.‘

California's highest court held Legislature intended to supersede the Compact's election provision.

Having ‘concluded the Legislature had the unilateral *authority* to eliminate the Compact's election provision,‘ the court below went on to determine that ‘both the language of section 25128 and its legislative history‘ indicatethat the Legislature also *intended* to eliminate the election provision. Thus, according to the California Supreme Court, California taxpayers may no longer elect to use the Compact's elective apportionment formula.

Question presented.

Noting that the Compact is ‘a multistate agreement that addresses significant aspects of the state taxation of multistate businesses,‘ Gillette and its counterparts now ask the U.S. Supreme Court whether ‘the Multistate Tax Compact has the statusof a contract that binds its signatory states.‘

Petitions Denied

Two previously reported petitions have been denied by the Court.

On 5/31/16, the Court denied the petition it received in *Sprint Nextel Corp. v. New York*, Docket No. 15-1041, petition for cert. filed 2/18/16, ruling below as *People v. Sprint Nextel Corp.*, 26 N.Y.3d 98 (2015). In its petition, Sprint Nextel Corporation (‘Sprint‘) had asked the Court to review a decision by the New York State Court of Appeals, in which New York's highest court held that: ‘(1) the New York Tax Law imposes sales tax on interstate voice service sold by amobile provider along with other services for a fixed monthly charge; (2) the statute is unambiguous; (3) the statute is not preempted by federal law (the Mobile Telecommunications Sourcing Act, 4 U.S.C. 123(b)); (4) the [New York State] AttorneyGeneral's complaint sufficiently pleads a cause of action under the New York False Claims Act ((FCA) (State Finance Law 187 et seq.)); and (5) the damages recoverable under the FCA are not barred by the Ex Post Facto Clauseof the U.S. Constitution.‘

Sprint had specifically asked the Court: ‘Whether New York law, which imposes sales tax on interstate mobile voice services only when it is bundled with other services, conflicts with the Mobile Telecommunications Sourcing Act, 4 U.S.C. 123(b), and istherefore preempted.‘

On 6/13/16, the Court denied the petition in *Seminole Tribe of Florida v. Stranburg*, Docket No. 15-1064, petition for cert. filed 2/19/16, ruling below at 799 F.3d 1324 (11th Cir. 2015). The U.S. Court of Appeals for the Eleventh Circuit held that federal law prohibits and preempts Florida's commercial rent tax (the ‘Rental Tax‘) from being imposed on the Seminole Tribe's leases of reservationland, but that Florida's tax on the gross receipts of utility service providers (the ‘Utility Tax‘) does not violate federal Indian law, even when the tax is passed on to Indian customers, because the legal incidence of the tax falls on the utilitycompany

and not on the Seminole Tribe. The Seminole Tribe had petitioned the High Court to review the circuit court's ruling with regard to the Utility Tax, arguing that the lower court ‘erroneously concluded that the legal incidence of the Utility Taxis on the utility company rather than on the Tribe‘ and therefore erroneously found the Utility Tax to be a permissible tax on the Tribe's activities.

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