In the Supreme Court of the State of California

THE GILLETTE COMPANY & SUBSIDIARIES, **Plaintiffs and Appellants,** v. CALIFORNIA FRANCHISE TAX BOARD, AN AGENCY OF THE STATE OF CALIFORNIA, **Defendant and Respondent.**

Case No. S206587

First Appellate District Division Four, Case No. A130803
San Francisco County Superior Court, Case No. CGC-10-495911
The Honorable Richard A. Kramer, Judge

REPLY TO ANSWER

KAMALA D. HARRIS
Attorney General of California
SUSAN DUNCAN LEE
Acting Solicitor General
KATHLEEN A. KENEALY
Chief Assistant Attorney General
PAUL D. GIFFORD
Senior Assistant Attorney General
W. DEAN FREEMAN
Supervising Deputy Attorney General
JOYCE E. HEE
Supervising Deputy Attorney General
LUCY F. WANG
Deputy Attorney General
State Bar No. 199772
455 Golden Gate Avenue, Suite 11000
San Francisco, CA 94102-7004
Telephone: (415) 703-5202
Fax: (415) 703-5480
Email: Lucy.Wang@doj.ca.gov
Attorneys for Defendant and Respondent Franchise Tax Board

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INTRODUCTION

The Franchise Tax Board ("FTB") requests this Court to review a decision holding that (1) the Multistate Tax Compact ("Compact") supersedes subsequently enacted legislation (Revenue and Taxation Code section 25128[1]) that changes the apportionment formula for taxation of multistate businesses; (2) section 25128 constitutes an impairment of contracts in violation of the contracts clauses under the state and federal constitutions; and (3) section 25128 violates the re-enactment clause of the California Constitution.

The Gillette Company & Subsidiaries ("Taxpayers") argue that the FTB "raises no serious question that any of these holdings was incorrect or that review is necessary to secure uniformity in the law." (Answer to Petition for Review ["Ans."] at p. 1.) That is not so. The questions raised here are serious ones, and the conflicts of law are real.

Review is necessary because (1) the decision affects tens of thousands of businesses in California, plus an untold number of businesses in the remaining 19 member states of the Compact; (2) the FTB estimates that the decision might require up to $750 million in tax refunds in California; and (3) the Court of Appeal's analyses under the contracts and re-enactment clauses conflict with existing law.

The decision below applies the law of congressionally ratified compacts to this Compact, even though this Compact has never been ratified or approved by Congress. There is no California authority for extending standard compact analysis to compacts that have not been ratified by Congress. In fact, the Supreme Court of the United States has held that the Multistate Tax Compact is not subject to the Compact Clause and is

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[1] Subsequent statutory references are to the Revenue and Taxation Code unless otherwise noted.

valid without congressional approval. (*United States Steel Corp. et al. v. Multistate Tax Commission et al.* (1978) 434 U.S. 452 [*U.S. Steel*]).

Moreover, the Court of Appeal failed to consider the fact that virtually every other Compact member state interprets the Compact in the same manner as California does, and that most member states have adopted multistate tax apportionment formulas substantially similar to the California statute invalidated by the decision below.

Finally, the Court of Appeal's analyses and conclusions with respect to the contracts and re-enactment clauses, which were central to its decision, clearly conflict with existing law.

ARGUMENT

I. THE POLICY CONSIDERATIONS THAT APPLY TO THIS UNIQUE MULTISTATE TAX COMPACT, WHICH HAS NOT BEEN APPROVED BY CONGRESS, COMPEL THIS COURT'S REVIEW

The Multistate Tax Compact is unique: there is no other compact like it in the nation. Although this case arises from a California statute implementing the Compact, the Court of Appeal's decision has implications for other Compact member states as well, as is confirmed by the eighteen member states' amicus support for the FTB's Petition for Review. The decision failed to consider the member states' longstanding interpretation of, and performance under, the Compact. Indeed, the decision threatens the very viability of the Compact.

Because the Compact is not congressionally approved, the Court of Appeal's reliance on "established compact law" is misplaced. There are only a few published cases involving non-congressionally approved compacts, and only one significant case, *U.S. Steel*, involving the constitutionality of this Compact. (*U.S. Steel*, *supra*, 434 U.S. at p. 452.) *U.S. Steel* held that the Multistate Tax Compact is not subject to the Compact Clause, and that it is valid despite not being congressionally

approved. (*Id.* at pp. 472-478.) *U.S. Steel* did not reach the question at issue here, which is whether the Compact, as interpreted by California and other Compact member states, allows a member state to supersede Compact provisions absent that state's complete withdrawal from the Compact. This question is critically important to California, to other Compact member states, and to the continuing existence of the Compact.

The FTB and the amici member states[2] share serious concerns about the Court of Appeal's decision. First, the ruling that California must offer Taxpayers an election between a three-factor apportionment formula and a state alternative apportionment formula, absent the member state's complete withdrawal from the Compact, conflicts with member states' longstanding construction of the Compact. Second, the alleged mandatory election interferes with state sovereignty over taxation issues. Third, the decision extends contract rights to Taxpayers, who are neither parties to, nor beneficiaries under, the Compact. Each of these issues is of vital importance not only to California but to other Compact member states as well.[3] Review should be granted to settle these important questions of law.

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[2] Amicus letters in support of FTB's Petition for Review have been filed by the States of Alabama, Alaska, Arkansas, Colorado, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, New Mexico, Oregon, North Dakota, South Dakota, Texas, Utah, Washington, and the District of Columbia.

[3] The decision below calls into question the legitimacy of actions by other Compact member states that have also enacted legislation altering the apportionment and election provisions of the Compact. These issues have been raised in three subsequently filed actions, in Michigan, Texas, and Oregon. The Michigan Court of Appeals recently examined the same issues that were presented to the court below. It reached a result contrary to the decision below, and in favor of Michigan, explaining that the Compact "does not appear to constitute a truly binding contract." (*International Business Corp. v. Department of Treasury* (Mich. Ct. App. Nov. 20, 2012,

(continued...)

II. REVIEW IS NECESSARY BECAUSE THERE ARE NO "ESTABLISHED PRINCIPLES OF COMPACT LAW" WHICH APPLY TO NON-CONGRESSIONALLY APPROVED COMPACTS

FTB has not admitted or conceded anything regarding so-called "bedrock principles of compact law," as claimed by Taxpayers.[4] Because merits arguments are presently premature, FTB will not belabor its view here that standard compact law principles do not apply to non-congressionally approved compacts.

It is particularly unfortunate that, in an area where case law is so scarce, the Court of Appeal's decision does nothing to resolve issues about how to interpret non-congressionally approved compacts. Instead, the decision muddies the waters by erroneously intertwining cases involving both congressionally approved and non-congressionally approved compacts. This Court's review would provide much needed guidance on these important issues of interstate compact law.

Review is necessary also because the decision erroneously interprets the Compact in a manner contrary to the member states' intent and construction. Eighteen Compact member states support the FTB's Petition for Review. Those Compact members are understandably concerned with the conclusions that member states are bound to the Compact's original

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(...continued)
No. 306618 at *10) 2012 Mich. App. LEXIS 2293, unpublished; request for publication filed Dec. 3, 2012.)

[4] This phrase is a misnomer. Both Taxpayers and the Court of Appeal fail to distinguish between congressionally approved and non-congressionally approved compacts. The distinction is important because congressionally approved compacts express federal law and require congressional approval for any changes to be made. The Compact at issue here did not receive or require congressional consent, and is not subject to the rules that govern those other compacts. (*See U.S. Steel, supra,* 434 U.S. at pp. 472-478.)

provisions absent a complete withdrawal, and that Taxpayers, even as non-parties to the Compact, may enforce that obligation against member states.

Finally, it is important to note that the Legislature has made subsequent amendments to the Revenue and Taxation Code that affect Compact provisions. Allowing the decision below to stand risks invalidation of these other tax provisions, which could throw multistate tax laws into disarray and lead to further litigation.

III. THE COURT OF APPEAL'S DETERMINATION THAT AMENDED SECTION 25128 VIOLATES THE CONTRACTS CLAUSE CONFLICTS WITH EXISTING LAW

Because Taxpayers were neither parties to, nor beneficiaries of, the Compact, the Court of Appeal's conclusion that section 25128 violates the contracts clauses of the state and federal constitutions conflicts with existing law. (*Fireman's Fund Ins. Co. v. Maryland Casualty Co.* (1994) 21 Cal.App.4th 1586, 1600; Civ. Code, § 1559.)

In addition, the Court of Appeal's analysis engenders confusion about how the contracts clauses operate in this area. Although the decision holds section 25128 unconstitutional "by its plain terms" because it "sought to override and disable California's obligation under the Compact to afford taxpayers the option of apportioning income under the UDITPA formula," (Slip Op. at p. 20) the opinion does not make clear whether California's obligation is statutory or contractual. The opinion does not distinguish between Taxpayers' statutory rights under the Compact and their purported contractual rights under the Compact. The failure to distinguish statutory rights from contractual ones compounds the confusion inherent in the court's determination that section 25128 operates as an *impairment of a contractual relationship* in violation of the contracts clauses of the state and federal constitutions. (See *Energy Resources Group, Inc. v. Kansas Power and Light Company* (1983) 459 U.S. 400, 411.)

The decision also conflicts with existing law when it relies on law that applies to congressionally approved compacts to prohibit any subsequent amendment or deviation from the terms of this non-congressionally approved Compact. Moreover, the decision is in conflict with, and violates, California's sovereign right and power to enact its own tax laws. Taxpayers' arguments to the contrary only reinforce the point that review is needed to resolve the conflicts of law that are raised by the Court of Appeal's decision.

IV. THE COURT OF APPEAL'S DETERMINATION THAT AMENDED SECTION 25128 VIOLATES THE REENACTMENT RULE CONFLICTS WITH EXISTING LAW

The decision below holds that section 38006 must be reenacted in an amended form to show the alleged deletion of an election provision. This conflicts with settled law holding that the reenactment rule does not apply where one statute amends or repeals another by implication. (*White v. California* (2001) 88 Cal.App.4th 298, 313-315; *Brosnahan v. Brown* (1982) 32 Cal.3d 236, 255-258; *Hellman v. Shoulters* (1896) 114 Cal. 136, 153.) Again, Taxpayers' arguments to the contrary underscore the need for review to resolve this important legal issue.

CONCLUSION

For the foregoing reasons, the Franchise Tax Board respectfully requests that the Court grant its Petition for Review.

Dated: December 13, 2012

Respectfully submitted,

KAMALA D. HARRIS
Attorney General of California
JOYCE E. HEE
Supervising Deputy Attorney General

LUCY F. WANG
Deputy Attorney General
Attorneys for Defendant and Respondent
Franchise Tax Board

SF2010900595

CERTIFICATE OF COMPLIANCE

I certify that the attached Reply to Answer uses a 13 point Times New Roman font and contains 1,891 words.

Dated: December 13, 2012

KAMALA D. HARRIS
Attorney General of California

Lucy Wang

LUCY F. WANG
Deputy Attorney General
Attorneys for Defendant and Respondent
Franchise Tax Board

DECLARATION OF SERVICE BY U.S. MAIL

Case Name: The Gillette Company & Subsidiaries v California Franchise Tax Board
Supreme Court Case No.: S2065887
Court of Appeal Case No.: A130803
San Francisco Superior Court Case No. CGC10495911

I declare:
I am employed in the Office of the Attorney General, which is the office of a member of the California State Bar, at which member's direction this service is made. I am 18 years of age or older and not a party to this matter. I am familiar with the business practice at the Office of the Attorney General for collection and processing of correspondence for mailing with the United States Postal Service. In accordance with that practice, correspondence placed in the internal mail collection system at the Office of the Attorney General is deposited with the United States Postal Service that same day in the ordinary course of business.

On December 13 2012, I served the attached

REPLY TO ANSWER

by placing a true copy thereof enclosed in a sealed envelope with postage thereon fully prepaid, in the internal mail collection system at the Office of the Attorney General at 455 Golden Gate Avenue, Suite 11000, San Francisco, CA 94102-7004, addressed as follows:

Amy L. Silverstein, Esq.
Edwin P. Antolin, Esq.
Silverstein & Pomerantz LLP
55 Hawthorne Street, Suite 440
San Francisco CA 94105

Jeffrey B. Litwak
1608 NE Knott Street
Portland OR 97212

Clerk of the Court
Court of Appeal
First Appellate District
350 McAllister Street
San Francisco CA 94102

Cory Fong, Tax Commissioner
Office of State Tax Commissioner
State of North Dakota
600 E. Boulevard Avenue, Department 127
Bismarck ND 58505-0599

Clerk of the Court
San Francisco Superior Court
400 McAllister Street
San Francisco CA 94102

Lawrence G. Wasden
Attorney General, State of Idaho
State of Idaho Office of the Attorney General
P.O. Box 83720
Boise ID 83720-0010

Ellen F. Rosenblum
Attorney General, State of Oregon
Department of Justice
Justice Building
1162 Court Street NE
Salem OR 97301-4096

R. Bruce Johnson
Commission Chair
Utah State Tax Commission
210 North 1950 West
Salt Lake City UT 84134

I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on December 13, 2012, at San Francisco, California.

Joan Randolph
Declarant


Signature

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