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August 11, 2013

Dear Legislator,

On behalf of the National Conference of State Legislatures Executive Committee Task Force on State and Local Taxation, we wanted to transmit the attached memorandum which discusses legal questions being raised regarding the impact of a state's membership in the Multistate Tax Compact. At the heart of those questions lays an important issue for states. Simply put, litigation is pending in four states seeking to determine whether membership in the Compact removes the state legislature's control over corporate income tax apportionment and certain tax base definitions.

In states that have modified the traditional three factor apportionment formula for determining corporate income subject to tax, out-of-state taxpayers are able to override the state's law electing instead to use rules provided by the Compact, even when those rules have not been legislatively adopted by the state. In two states, lower courts have held taxpayers may elect to be taxed under the rules of the Compact rather than the provisions adopted by the state legislature. *See Gillette Co. v. Franchise Tax Bd.*, 209 Cal. App. 4th 938 (2012) and *Anheuser-Busch, Inc. v. Mich. Dept. of Treasury*, No. 11-85-MT (Mich. Ct. Cl., June 6, 2013). In reaction, the legislatures in five states and the District have acted to attempt to maintain control of their state apportionment regimes. California, District of Columbia, Minnesota, Oregon, South Dakota, and Utah have all withdrawn from the Compact or are seeking to eliminate the binding nature of the Compact's apportionment scheme.

At the August 11, 2013 meeting of the National Conference of State Legislatures Executive Committee Task Force on State and Local Taxation, we discussed these issues and voted to communicate the attached memorandum to legislators in states that were members of the Compact. The memorandum was prepared for discussion at the Task Force meeting by a state tax lawyer who represents taxpayers in front of the Task Force. We would encourage you to read the attached memorandum and evaluate the issues facing your state as a result of its membership in the Compact and the growing number of lawsuits following on *Gillette*.

If you have questions or would like additional information, please contact us or Neal Osten, in NCSL's Washington office at neal.osten@ncsl.org.

Sincerely,

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MEMORANDUM

Date: August 2, 2013

To: NCSL Task Force on State and Local Taxation

From: Stephen P. Kranz

Re: Issues Raised by State Membership in Multistate Tax Compact

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Recent litigation in several states raises important issues regarding the ability of states that are members of the Multistate Tax Compact ("Compact Members") to independently determine the parameters of their corporate income/franchise tax ("corporate income tax"). These issues will affect both the revenue raised from the corporate income tax in future years and a Compact Member's liability for tax refunds for past years. Compact Members may also risk having pending amendments to the Compact imposed upon them in order to maintain their membership status. How Compact Members respond to the obligations imposed by the Multistate Tax Compact could also have repercussions for other interstate compacts on which states rely. Finally, the litigation raises a question regarding whether states, both Compact Members and other states, may validly use the Commission as an arm of government in conducting taxpayer audits.

We describe the issues below, as well as the reasons that these issues are becoming important now.

Background

The Multistate Tax Compact was created to facilitate proper determination of state and local tax liability of multistate taxpayers; promote uniformity or compatibility in significant components of tax systems; facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and avoid duplicative taxation. Multistate Tax Compact, Article I. Seventeen jurisdictions are currently Compact Members: Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Missouri, Montana, New Mexico, North Dakota, Oregon, Texas, Utah, and Washington. Typically, a state becomes a Compact Member by passing legislation adopting the Compact. The Multistate Tax Compact is available at: http://www.mtc.gov/About.aspx?id=76.

The Compact has several sections explaining how the agreement operates. Article VI established the Multistate Tax Commission. The Commission operates as the administrative body for the Compact Member. Compact Members each have a vote on Commission business, including whether to adopt model statutes, rules, etc. dealing with multistate tax issues.

Article IV specifically adopts the Uniform Division of Income Tax Act (UDITPA) as an element of the Compact. UDITPA was created by the Uniform Laws Commission and provides

a sample statute for states to use in crafting typical state corporate income tax definition and sourcing (allocation and apportionment) laws. Definition and sourcing laws are the primary means by which a state determines how much of a multistate corporate taxpayer's total taxable income will be taxed by that jurisdiction. In the absence of the Compact, there is no requirement that any state conform to UDITPA and most states have either not conformed at all, or have adopted UDITPA with significant alterations or amendments. UDITPA was adopted by the ULC in 1957 and has remained unchanged. Compact Members are able to adopt unique definition and sourcing rules diverging from UDITPA because the Compact by its language does not prohibit state specific allocation and apportionment rules.

Article III of the Compact allows a multistate corporate taxpayer to choose whether to use the UDITPA rules or state specific rules (if they differ) to calculate its corporate income tax liability in a Compact Member. Most Compact Members never adopted Article III, repealed Article III, or implemented a separate statute nullifying Article III. The election provision was ignored for many years but recently, as Compact Members adopted laws that not only varied drastically from UDITPA but also from other states, multistate business taxpayers began using the election to opt-out of the state specific rules.

As a result of taxpayers claiming the right to use the Article III election even if a Compact Member took the position the election was not operable (whether because its legislature repealed Article III or never adopted it), significant litigation over the issue has arisen. Litigation is currently underway in at least four states, with more expected, to adjudicate whether membership in the Compact removes a legislature's ability to prevent application of the Article III election. Lower courts in Michigan and California have held that the state is bound by the election as a result of its status as a Compact member while at least one court in Michigan has held for the State. *See e.g. Anheuser-Busch, Inc. v. Mich. Dep't of Treasury*, No. 11-85-MT (Mich. Ct. Cl., June 6, 2013); *Gillette Co. v. Franchise Tax Bd.*, 209 Cal. App. 4th 938 (2012) (holding the state is bound by the MTC election). *Cf. Int'l Bus. Mach. Corp. v. Dep't of Treasury*, No. 306618 (Mich. Ct. App., Nov. 20, 2012)(appeal to Mich. Sup. Ct. granted July 3, 2013)(holding for the State). Cases in Texas and Oregon are pending at the trial level tribunal. *See e.g. Graphic Packaging Corp. v. Combs*, District Court of Travis County, Tex., 353rd Judicial District, No. D-1-GN-12-003038 (complaint filed Sept. 27, 2012); Health Net, Inc. v. Or. Dept. of Rev., Or. T.C., No. TC 5127 (amended complaint filed Jan. 17, 2013). The Michigan and California cases are being appealed. (All Article III litigation in the various states will be referred to herein as "*Gillette* litigation"). In addition to taxpayers that have cases pending in the various Compact Members, dozens, perhaps hundreds of taxpayers, have refund claims pending for prior years as a result of claiming the election. Furthermore, taxpayers are beginning to make the election on original returns filed for current periods.

The legal theory as to why a taxpayer is entitled to the election in a Compact Member state even if the Member has attempted to remove the election or never adopted it is a result of the application of the unique field of state compact law. If a state enters into a compact, the compact is both a statute passed by the legislature and a contract binding on the state that cannot be unilaterally altered by the state. The issues raised by the Article III litigation include whether the Multistate Tax Compact is the type of agreement creating a contract among the states and whether the Article III election was intended to be mandatory for Compact members.

The ongoing controversy surrounding the validity of the election has caused significant uncertainty for both Compact Members in making revenue estimates and for taxpayers in deciding how to properly comply.

Issues:

1. Does a state's status as a Compact member force the state to allow taxpayers to elect to use the UDITPA rules, even if the choice is inconsistent with the law adopted by the state's legislature?

As noted above, this is the primary topic of the ongoing litigation in the various Compact Members.

2. If a Compact Member wants to avoid application of the election, how can this be accomplished?

Five states and the District have withdrawn from Compact membership in the last fourteen months. The only failsafe method for a Compact Member is to withdraw from the Compact itself. California, the District, Minnesota, Oregon, South Dakota and Utah have all recently enacted legislation withdrawing from the Compact or seeking to eliminate the binding nature of the Compact's UDITPA regime. Utah, Oregon, and the District sought to avoid application of the election while remaining Compact Members by repealing and reenacting the Compact without the Article III provision. The validity of this method may not ultimately be successful because if taxpayers prevail in the *Gillette* litigation, the Compact is an all or nothing proposition and (absent an explicit option in the Compact itself) a state cannot pick and choose which parts of the Compact it wants to adopt.

Compact Members are also confronted with an issue as to whether a retroactive repeal of the Compact could limit taxpayers' ability to file refund claims based on the election for prior periods. Some states, like California have attempted a retroactive repeal. California passed legislation in 2012 repealing the Compact as of 1993. Cal. S. 1015 (2012) (enacted). Due process concerns may prevent a retroactive repeal from being effective.

Potentially ineffective repeals, such as effectively repealing only Article III or a retroactive repeal, could result in even more litigation and leave unresolved (or exacerbate) the fiscal and compliance questions.

3. Do subsequent amendments to the Compact bind Compact Members even if a Compact Member's legislature does not adopt the amendments?

The Commission, as the body responsible for administering the Compact, has drafted an amendment to the Compact titled, "Multistate Tax Compact Article IV Recommended Amendments." These proposed amendments are poised to be considered and adopted by the Multistate Tax Commission at an upcoming meeting. If adopted the amendments would further revise the Compact's definitions and sourcing rules. As such, action by the Multistate Tax Commission on the amendments (through a vote of its members), could have additional repercussions for the law applicable in Compact member states. If a State does not adopt the amendments, the amendments may be imposed on it as a Compact Member in the same manner

that the Article III election is being forced on the states. Adoption of the amendments could lead to additional litigation over whether taxpayers were entitled to the benefit of the amendments, even if they are not adopted by a Compact member state's legislature. The result could again lead to unexpected revenue impacts (potentially both positive and negative depending on a state's current definition and sourcing rules) or disqualification from participation in important Commission programs such as the multistate audit program (see below for further discussion of this program).

4. Can a non-Compact Member participate in the Commission's audit program?

The Compact is also the basis for the Commission's authority to conduct multistate tax audits on behalf of participating states. The legitimacy of that program, and audits being conducted through it on the states' behalf, are now being questioned by taxpayers concerned that the Compact may not be held to be a binding compact. In short, if the Compact is not a binding Compact on its member states then it is the view of many in the taxpaying community that the Commission lacks the legal authority to conduct audits on behalf of both Compact members and non-members. Furthermore, the plain language of the Compact may prevent non-Compact members from participating in the audit program. Thus, Compact Members may be faced with choosing between accepting loss of control over part of their corporate income tax imposition or losing the revenue generated from the Commission's multistate tax audits.

5. How does a Compact Member's interpretation of its obligations under the Compact affect its participation in other multistate compacts?

Finally, how a Compact Member interprets its obligations under the Multistate Tax Compact has implications that reach beyond the state's business tax structure. The National Center for Interstate Compacts lists 208 existing interstate compacts, including compacts governing such important topics as water rights. If a Compact Member successfully asserts authority to unilaterally change the terms of the Multistate Tax Compact, what is to prevent other states from unilaterally changing terms of other compacts, to the detriment of the Compact Member and its citizens?

Conclusion

The recent increase in taxpayers using the Compact election, the probability that courts will uphold the availability of the election, the lack of clarity as to the effect of pending amendments on Compact Members, and the risk of upsetting settled expectations for unrelated interstate compacts all counsel Compact Members to carefully consider the impact of membership in the Multistate Tax Compact and changes being considered to that Compact.