What Does the Future Hold For the MTC?

by Cara Griffith

The last two Practice Notes columns have addressed California’s application of the judicially created doctrine of election and questions for taxpayers in light of the California Court of Appeal’s opinion in The Gillette Co. et al. v. Franchise Tax Board. This article continues the focus on the ramifications of Gillette by exploring what the future might hold for the Multistate Tax Commission and the Multistate Tax Compact, and addressing states’ possible moves to minimize the effect of the opinion.

The MTC and the Compact

Although the MTC needs little introduction to readers of State Tax Notes, a bit of background may nonetheless be useful. The MTC was established by the compact in 1967 as an intergovernmental agency that would work on behalf of states and taxpayers “to administer, equitably and efficiently, tax laws that apply to multistate and multinational enterprises.” The MTC seeks to:

Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;

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.2

The impetus for the compact was the creation of some level of uniformity among state tax systems, which was seen to be lacking in the 1950s, and avoidance of federal intervention in the state taxation of interstate businesses. The stage was set for the compact when, in 1957, the National Conference of Commissioners on Uniform State Laws adopted the Uniform Division of Income for Tax Purposes Act, which provides for the apportionment of a multistate business’s income using an equally weighted three-factor formula.

But by 1959 few states had adopted UDITPA. In that year the U.S. Supreme Court issued a decision in Northwestern Cement Co. v. Minnesota, upholding the ability of Minnesota to impose corporate franchise tax on an Iowa corporation that had an office in Minnesota and salespeople soliciting orders in the state.3 The Court announced that “net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same.”

The opinion was troublesome for multistate businesses because it was unclear what gave rise to the Iowa corporation’s nexus with the state and whether the solicitation of orders in the state was sufficient to create nexus. In response to businesses’ concerns, Congress enacted Public Law 86-272 and created a subcommittee to study the state taxation of multistate businesses. The study that came out of the subcommittee, known as the Willis Report, recommended federal legislation that limited states’ ability to tax multistate businesses and the imposition of a uniform apportionment formula.4

1California Court of Appeal, Case No. A130803. For the October 2 opinion, see Doc 2012-20514 or 2012 STT 192-7. For the July 24 opinion, see Doc 2012-15737 or 2012 STT 143-20.

2Multistate Tax Compact, Art. I.


Out of fear that Congress would eventually enact legislation that infringed on states’ taxing powers, several state taxing officials, through the Council of State Governments and the National Association of Tax Administrators, came up with the idea of a Multistate Tax Compact. The compact and the commission were officially enabled on August 4, 1967, after seven states adopted its provisions. As it was conceived, the compact was not a formal congressionally sanctioned compact with binding regulatory authority. Instead, the compact was intended to permit states to retain the ability to pursue their own policy agendas via their tax systems.5

Although state authorities may have wanted the compact to be flexible and nonbinding, the compact is nonetheless, exactly that: a compact.

In its amicus brief in support of the Franchise Tax Board in Gillette, the MTC argued that in joining the compact, “members did not surrender any aspect of state sovereignty to tax.” Citing U.S. Steel Corp. v. Multistate Tax Commission, the MTC said that joining the compact does not delegate any sovereign power to the commission, rather “each State retains complete freedom to adopt or reject the rules and regulations of the Commission.”6

Although state authorities may have wanted the compact to be flexible and nonbinding, the compact is nonetheless, exactly that: a compact. The California appellate court said in Gillette that because “interstate compacts are agreements enacted into state law, they have dual functions as enforceable contracts between member states and as statutes with legal standing within each state.” The court held that for California and other states that are signatories to the compact, there are “binding reciprocal obligations that advance uniformity.” One of those obligations is the election provision, under which the equally weighted three-factor UDITP A apportionment formula is made available to taxpayers on an optional basis. Although states may provide taxpayers with alternative formulas (such as a double-weighted sales factor or single sales factor) the uniformity provided in the UDITP A formula must also be available.

What Now?

In a well-researched and well-written opinion, the Gillette court appropriately concluded that the compact, as “both a statute and a binding agreement among sovereign signatory states,” was binding on California and could not be unilaterally altered or amended. Although there were obvious budgetary reasons for a contrary conclusion, had the court decided otherwise, the compact would, for all intents and purposes, have been a sham; a compact with missing or very dull teeth.

As the Gillette litigation unfolded, the MTC as an institution and the compact came under fire. The future of the MTC has been debated in the pages of State Tax Notes for more than a year.7 But what does Gillette really mean for the MTC and the compact? Although the opinion may be challenging for the MTC in the short run, Gillette affirmed the validity and enforceability of the compact, which is arguably a good thing. It could be empowering for the MTC in that the compact can be used to directly promote uniformity. The MTC can do more than what it states as its purpose in its amicus brief in Gillette, which is to act as a forum “to advance the growth and enlargement of uniformity.” The MTC may be able to directly promote uniformity among states.

Still, unless a contrary opinion is issued in California or another court, states must question whether they too are precluded from doing what California attempted to do by providing in RTC section 25128 that “notwithstanding section 38006” (the compact provision) the only apportionment method available to multistate corporations is the double-weighted sales factor formula. That is, states cannot change their tax laws to prevent taxpayers from having a right to elect to use the UDITP A equally weighted, three-factor apportionment formula. If the states are unable to change their apportionment formulas to accommodate their tax policy, some states may question the benefits of the...
compact. There are many known benefits of uniformity; however, based on the MTC's history and its arguments in its amicus brief in Gillette, states may find uniformity more a burden than a benefit.

Withdrawal of State From the Compact?

How states respond to Gillette is still unknown, but given that California's first reaction to an impending loss in Gillette was to withdraw from the MTC, it is possible that other states will follow suit. Still, said Jeffrey Reed, an associate with Mayer Brown LLP, “member states have not been rushing for the exits.” His sense is that member states are watching litigation in Texas, Michigan, and Oregon to determine whether the California court's opinion in Gillette was an aberration or whether additional taxpayer-friendly opinions will be issued. If the binding nature of the compact is repeatedly upheld, Reed said, “it would not be surprising to see at least a few member states withdraw. For now, member states seem to be following a wait-and-see approach. It also may be that this issue and the potential revenue effects have not hit home with lots of member states yet because they do not currently have compact election litigation pending in their state courts. Once refund claims are filed, then the issue is likely to receive more attention.”

If other states do begin to distance themselves from the MTC, that could reduce the level of transparency the MTC has achieved. As noted above, there are Gillette-like cases pending in Texas, Michigan, and Oregon. Each of those states, like California, is a full compact member. For example, in Oregon, Health Net Inc. filed suit in the state's tax court, arguing that it had a right to use the compact's apportionment formula, rather than the statutorily required single-sales-factor apportionment formula.8 A similar case is pending in the Michigan Court of Appeals.9

In Texas, Graphic Packaging Corp. filed suit in Travis County District Court, arguing that it had a right to elect to use the compact's equally weighted three-factor apportionment formula on its 2010 margins tax report and for refund claims from tax years 2008 and 2009. Although the comptroller has, on five occasions, denied taxpayers the ability to apportion business income under the compact's UDITPA formula, including an opinion post-Gillette denying the election to Graphic Packaging, this will be the first time a Texas court has the opportunity to weigh in.10

The Texas case will be interesting to watch for a number of reasons, including because it involves the Texas margin tax, which has characteristics of an income tax but is decidedly different. Although most state courts will rely on Gillette, said Richard Kariss, a partner with Alston & Bird LLP, Graphic Packaging could be decided in a number of ways. It raises several questions, including several constitutional issues. However, if it is decided on the validity of the compact election, the opinion will likely be similar to Gillette. “Compact election provisions, which are written into state statute, will be difficult for a court to ignore,” said Kariss. Also, the Gillette opinion was well-reasoned and “other courts will be hard-pressed not to follow it,” he said.

Amending the Compact

To prevent states from withdrawing, there has been speculation that the MTC might amend the apportionment formula in the compact. MTC Executive Director Joe Huddleston has said that although the compact's goal is to promote uniformity, “it isn’t the kind of compact that demands uniformity — either in general or in specific terms like the provisions in UDITPA.” In a discussion with Billy Hamilton, Huddleston said:

Critics make a lot out of the fact that the FTB's ruling on the three-factor issue moves away from uniformity, but if you think about it, you can make the case that the opposite is true. The case grew out of the fact that California is moving toward other states by more heavily weighting sales even if it is moving away from UDITPA. You can argue whether that's going to pay off for the states in the long run, but you can't argue that the states aren't becoming more uniform on the issue of formula apportionment. They just aren't following the approach that UDITPA envisioned.11

Given that, it seems likely that the MTC will at least consider reevaluating the terms of the compact. One possible option for the MTC is to revisit factor weighting in the compact's apportionment formula. The issue was considered at the MTC's 2011 fall meeting, but no decisions were made.12 At the time, MTC General Counsel Shirley Sicilian also acknowledged that states are moving away from the equally weighted three-factor formula. Like Huddleston, however, she noted that states were largely in agreement on the direction they were moving. Sicilian wrote in a 2011 memorandum to the Income and Franchise Tax Uniformity Subcommittee, that

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8For prior coverage of the case, see State Tax Notes, Oct. 8, 2012, p. 87, Doc 2012-20297, or 2012 STT 190-30.
9International Business Machines Corp. v. Dep't of Treasury, Dkt. No. 306618.
12For prior coverage, see State Tax Notes, Nov. 21, 2011, p. 495, Doc 2011-24013, or 2011 STT 221-2.
the states are “at least moving away in the same direction — toward more heavily weighting the sales factor.”

Although states may want to more heavily weigh the sales factor, should the MTC change the compact’s current equally weighted three-factor formula, which arguably is still the best measure of a business’s activity in the state, to a formula that simply represents the direction in which states are moving? The answer to that question is complicated by the fact that the MTC was intended to promote uniformity in state taxation, not necessarily tax policy. Tax policy decisions have been left to the states. Still, if the MTC does not change the compact’s current formula to something that more closely conforms to what states have enacted, the MTC risks losing additional members, which goes against its efforts at uniformity.

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Despite the speculation about the likelihood that the compact will be amended, the MTC has yet to act (publicly) on that front. Reed speculated that there may be a few reasons for the MTC’s inaction. First, he said, “the scope of a potential amendment is unclear.” It would be possible to amend the compact to allow for three-factor apportionment with a double-weighted sales factor, but that “would not prevent taxpayers from making a compact election to take advantage of other provisions,” such as the UDITPA definitions of business and nonbusiness income. “The only amendment guaranteed to stop the bleeding would be to repeal the compact election provided for in Article III,” Reed said. “But that would mean gutting the meat of the compact and the part of the compact designed to help achieve uniformity, which may be perceived as an undesirable result.”

Second, even if an amendment could be agreed on, there is no guarantee that all states would enact the amendment. Reed noted that interstate compacts are not self-executing contracts; they must be enacted into law by states. The general process is that states must enact amendments into law through the legislative process.

Reed said that “in the case of several other interstate compacts, suggested amendments to the compacts were proposed by oversight bodies and some states enacted the amendments and others did not,” which creates a uniformity issue. “If an amendment was proposed and not all states enacted it, this would only support the chorus of critics arguing that the MTC is not helping to achieve uniformity,” Reed said.

Third, amending the compact now may be poor strategy for the MTC. “The optics are poor in connection with the ongoing litigation,” said Reed. “Amending the compact now in the wake of Gillette might suggest that the compact as it currently stands allows for a UDITPA election.” The MTC argued against that proposition in Gillette. An amendment to the compact now might suggest to taxpayers (and courts) that before the date of amendment, the MTC and states believe the compact provides for a UDITPA election. “Presumably,” said Reed, “the MTC and member states want to avoid doing anything that could be perceived as weakening their position in pending litigation.”

**Options for the States to Avoid Refunds**

States, and in particular MTC member states, are certainly watching the Gillette litigation as well as litigation in Texas, Michigan, and Oregon. But at this point, none are willing to speculate what the future might hold. If, as practitioners predict, Gillette is upheld on review or other state courts issue opinions that affirm the validity and enforceability of the compact, states will be in a difficult position and surely will be looking for ways to minimize the amount of refunds that must be issued.

California attempted to avoid those refunds by enacting SB 1015, the questionably valid legislation that withdraws California from the compact and declares that taxpayers cannot elect to use the compact’s equally weighted three-factor formula on an amended return in light of the doctrine of election.

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Ethan Millar, a partner with Alston & Bird LLP, outlined the basic problems with SB 1015. First, the legislation is arguably invalid under Proposition 26, which requires a supermajority vote if a change in state statute will result in any taxpayer having a higher tax liability. Second, invoking the doctrine of election is problematic. Whether SB 1015 can require the doctrine to be applied “gets back to the question of what Gillette stands for. Because the compact is a binding agreement, California cannot unilaterally alter or change its terms,” Millar said.

In essence the legislation requires that taxpayers make an election to use the compact’s equally weighted three-factor formula on an original timely
filed return. That election, once made, is then binding. However, taxpayers were unaware that they could make the election. Applying the doctrine retroactively to an election that taxpayers were unaware of and that the FTB denied could be made is unfair to taxpayers, Millar said.

Reed agreed, saying retroactive legislation that imposes a new requirement that taxpayers could not possibly have been aware of at the time is not the right solution. “Part of California’s calculus here appears to be that even if SB 1015 is ultimately declared invalid, it still provides a basis for not paying refund claims for at least a few years while the SB 1015 litigation works its way through the courts,” Reed said. “This is not a principled basis for rushing a statute through the Legislature. Hopefully other states will take the high road and will resist enacting SB 1015-type legislation.”

Conclusion

The future for the MTC is uncertain. There is no question that the MTC has a valid purpose and brings a significant amount of tax expertise to the table. Also, the commission conducts multistate audits and works on nexus programs and uniformity matters. However, Gillette raises questions about the commission and the compact. From a historical standpoint, the compact was created not because states truly wanted uniformity, but because they didn’t want the federal government interfering in matters of state taxation. As a result, state representatives created what they believed to be a solution that would both encourage uniformity and not get in the way of individual state tax policy. Gillette may come to symbolize that states can’t have their cake and eat it too; a compact cannot be both binding and offer states significant choices on whether to follow its terms.

Cara Griffith is a legal editor of State Tax Notes.
State Tax Notes Correspondents

Alabama: Bruce Ely, Bradley Arant Boult Cummings LLP

Alaska: Joe Hanel

Arizona: Joe Hanel

Arkansas: Rob Moritz

California: Lenny Goldberg, California Tax Reform Association; Chris Micheli, Aprea & Micheli Inc.; Kathleen K. Wright, California State University, Hayward; Greg Moran, The San Diego Union-Tribune

Colorado: Joe Hanel

Connecticut: Charles H. Lenore, Day Pitney LLP

Florida: Joe Follick

Georgia: Tim L. Fallaw and Ethan Millar, Alston & Bird LLP

Hawaii: Lowell Kalapa, Tax Foundation of Hawaii

Idaho: Dave Wasson

Illinois: Elizabeth Carvlin; Garland Allen

Indiana: Niki Lohrmann

Iowa: Elizabeth Carvlin

Kansas: Chris W. Courtwright, Kansas Legislative Research Department

Kentucky: Mark F. Sommer, Mark A. Loyd Jr., Michael A. Grim, Jennifer Y. Barber, and Daniel G. Mudd, Bingham Greenebaum Doll LLP; Charlie White

Maine: Douglas Rooks

Massachusetts: Neil Downing

Michigan: Suzette Hackney

Minnesota: Dale Busacker, Grant Thornton; Elizabeth Carvlin


Montana: Greg Tuttle

Nebraska: Elizabeth Carvlin

Nevada: Noah Austin; John S. Bartlett


New Jersey: Michael A. Guariglia, McCarter & English LLP; Jeff Pillets

New York: Irwin Slomka, Morrison & Foerster LLP

North Carolina: Jack Cummings, Alston & Bird LLP; Kay Miller Hobart

Ohio: Elizabeth Carvlin; J.M. Ortega

Oklahoma: Kenneth L. Hunt, Hall Estill

Oregon: Tim Christie

Pennsylvania: Thomas Fitzgerald

Rhode Island: Brian C. Jones

Tennessee: Michael D. Sontag, Bass, Berry & Sims PLC; Tom Humphrey

Texas: Bill Kidd, Long News Service

Utah: Dan Harrie

Vermont: Neil Downing

Virginia: Craig Bell, McGuire Woods Battle & Boothe LLP

Washington: Dave Wasson

West Virginia: Thomas D. Miller

Wisconsin: Todd A. Berry, Wisconsin Taxpayers Alliance

Wyoming: Erin Taylor, Wyoming Taxpayers Association