Montana Department of Revenue

Mike Kadas
Director

Steve Bullock
Governor

MEMORANDUM

TO: Mike Kadas, Director

FROM: C. A. Daw, Chief Legal Counsel

DATE: September 23, 2013

RE: NCSL Memo

The Revenue and Transportation Interim Committee has recently posted on its website a letter to Senator Jeff Essmann from the National Council of State Legislators and a memo from Stephen P. Kranz (an attorney who typically represents industry interests).

These documents raise issues regarding the interaction between state laws for the apportionment of corporate income and the Multistate Tax Compact[1] provisions for apportionment of corporate income where they differ. In Montana's instance, no differences have arisen between the Compact and the tax statutes regarding apportionment that are codified in Title 15, Chapter 31, Part 3, MCA

Accordingly, these documents have little if any relation to Montana at this time. The memo would only become relevant if the Montana Legislature were to consider modifications to Montana's apportionment formula. However, the Department currently has no plans to propose such an amendment and is unaware of any other parties planning to propose such an amendment.

Furthermore, if consideration of the Kranz memo ever does become necessary, there are several issues to that would need to be discussed and considered regarding the legal accuracy and the advocacy positions that are presented in that document.

For additional background on this matter, I have attached the MTC response dated September 5, 2013 and a News Analysis from the September 9, 2013 issue of the national publication *State Tax Notes*.

Attachments

[1] The Multi State Tax Compact is codified at Section 15-1-701, MCA.

MULTISTATE TAX COMMISSION
Maximizing the synergies of multi-state tax cooperation

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September 5, 2013

To: Governors, legislators, and tax administrators of states that are party to the Multistate Tax Compact

RE: Letter of August 28, 2013 from the NCSL Executive Committee Task Force on State and Local Taxation

You may have received a letter dated August 28, 2013, from the NCSL Executive Committee Task Force on State and Local Taxation. This letter attached a memorandum from Stephen P. Kranz of McDermott Will & Emery regarding "Issues Raised by State Membership in Multistate Compact." The letter and the memorandum are inaccurate in their representations of the Multistate Tax Compact and incomplete in their information regarding the current litigation related to Article III of the Compact. Simply put, although the Commission would not normally respond to a communication of this nature, the effect of the inaccuracies and lack of complete information is so misleading that we are compelled to do so.

INACCURACIES ADDRESSED

Q. Can your state be bound by rules "even when those rules have not been legislatively adopted by the state"?

A. No (setting aside federal rulemaking for purposes of this discussion). Moreover, your state's laws create and sustain the Commission. Your state's top tax official is a member of the Commission established by the Compact that your state's legislature adopted and your state's governor signed into law.

Q. Can the Commission adopt or do anything that imposes rules on your state or binds your state's legislature with respect to tax policy or binds your state's executive branch with respect to tax administration?

A. Again, despite the representations in the letter and memorandum, the answer is no. Article VII of the Compact is the article that provides for the Commission's uniformity work. The very last section of Article VII provides that states consider any such regulation (by convention, any uniformity proposal) for adoption "in accordance with its own laws and procedures." Therefore, your state—not the Commission—determines which rules will apply to your state. The Commission simply adopts recommendations for uniform tax administration. The U.S. Supreme Court agrees: "[E]ach State retains complete freedom to adopt or reject the

rules and regulations of the Commission." *U.S. Steel Corp.* et al. v. *Multistate Tax Commission*, et al., 434 U.S. 452 (1978).

So no state is "at risk" of anything with respect to the uniformity activities of the Commission. The Commission consists of the head of each state agency charged with the administration of income taxes or sales and use taxes for those states which have adopted the Multistate Tax Compact (Compact, Art. VI). As an intergovernmental state tax agency, the Commission has, from its inception in 1967, always functioned as an adjunct to your state's tax agency in an advisory role. The U.S. Supreme Court called it in *U.S. Steel* in 1978: There never was any "delegation of sovereign power" to the Commission. We work for you and your state.

INCOMPLETE INFORMATION CORRECTED

Q. What is at issue in *Gillette Co.* v. *Franchise Tax Bd.*, 209 Cal. App. 4th 938 (2012) and those other cases?

A. The core issue in those cases is an election that most states adopted when they adopted the Multistate Tax Compact. This election, contained in Article III, on its face allows multistate taxpayers to follow Article IV of the Compact, which contains the Uniform Division of Income for Tax Purposes Act (UDITPA), or the state's laws, if different, with respect to allocation and apportionment. As Compact states began to deviate from UDITPA with respect to allocation and apportionment, they used various methods to disable the election. *Gillette* deals specifically with California's method of disabling the election, and the other cases deal with the viability of the election as it related to those specific states' laws and history.

The issue common to all of these cases is whether or not the Compact is a binding contract among the party states that may not be unilaterally modified (e.g., through some lawmaking to disable the Article III election). The taxpayers in these cases are asserting that this is so, and that they are entitled to the election. The states assert that the Multistate Tax Compact is not a regulatory or boundary compact that requires it to be absolutely binding on all the states that are party to it, but rather an advisory compact allowing some individual state variation acceptable to the other Compact states. The Commission's legal staff has been active in their support for the states facing these cases, and will continue to be so.

There are several cases beyond the administrative stage; the letter and memorandum highlighted the only two where the taxpayers prevailed. *Gillette* is the furthest along, with briefing nearly done in the California Supreme Court. The taxpayers won at the appellate court level in *Gillette*. Also pending at the state supreme court level is the first of three Michigan cases, *Int'l Bus. Mach. Corp.* v. *Dep't of Treasury*, No. 306618 (Mich. Ct. App., Nov. 20, 2012). The state prevailed at the appellate level. Two other Michigan cases are being appealed from a lower court level, one a taxpayer win, *Anheuser-Busch, Inc.* v. *Mich. Dep't of Treasury*, No. 11-85-MT (Mich. Ct. Cl., June 6, 2013), and the other a state win omitted from the letter and memorandum you received, *Lorillard Tobacco Co.* v. *Mich. Dep't of Treasury*, No. 11-93-MT (Mich. Ct. Cl., Oct. 22, 2012). Cases in Texas and Oregon are pending at the trial court level, *Graphic Packaging Corp.* v. *Combs*, District Court of Travis County, Tex., 353rd Judicial

District, No. D-1-GN-12-003038; and *Health Net, Inc.* v. *Or. Dept. of Rev.*, Or. T.C., No. TC 5127.

CONCLUSION

The litigation regarding the Article III election is a significant matter for Compact states. Because of its significance, we do encourage you to discuss these matters with your state's top tax and legal officials, and not rely on self-serving advice from private industry interests.

The Commission's staff is also ready to address any questions and concerns you may have and continue to serve your state's interests as it has been doing for more than 45 years. Please do not hesitate to contact Joe Huddleston, Executive Director, or Shirley Sicilian, General Counsel, at jhuddleston@mtc.gov or ssicilian@mtc.gov, respectively, or by calling the Commission at 202-650-0300.

Julie P. Magee
Revenue Commissioner, Alabama
Chair, Multistate Tax Commission

Joe Huddleston
Executive Director
Multistate Tax Commission

NEWS ANALYSIS

Compact Issues: What's Steve Kranz Got Cooking?

by Amy Hamilton — amy_hamilton@tax.org

Tax Analysts will be publishing articles over the next several months analyzing developments regarding the Multistate Tax Compact, the Multistate Tax Commission, and related litigation and legislation in the states.

* * *

Stephen Kranz of McDermott Will & Emery has a penchant for masterfully advocating on behalf of his corporate clients while also stirring the pot. He's at it again as the author of a memorandum circulating among lawmakers nationwide that discusses legal questions raised by a state's membership in the Multistate Tax Compact, given the California Court of Appeal decision in *Gillette Co. v. Franchise Tax Board*.

Kranz and Diann Smith, also of McDermott Will & Emery, presented the memo in Atlanta at the annual legislative summit of the National Conference of State Legislatures. Their audience was the NCSL Executive Committee Task Force on State and Local Taxation — the same group that has opposed all efforts to revise the Uniform Division of Income for Tax Purposes Act and has questioned the appropriateness of some uniformity projects undertaken by the Multistate Tax Commission.

"States are going to address the ramifications of *Gillette* and its progeny one way or another," Kranz told Tax Analysts. "The right place for that discussion to start is in the legislative community and not at the Multistate Tax Commission."

The memo, prepared on behalf of the State Tax Policy Coalition, one of Kranz's corporate clients, provides background on the compact's creation, the inclusion of UDITPA as the apportionment formula in Article IV, and the Article III election allowing out-of-state taxpayers to choose between apportioning their business income to a member state under the UDITPA rules or a state's own formula. Kranz wrote that the election provision was ignored for many years, but that with compact members recently adopting laws that varied both from UDITPA and from other states' laws, multistate business taxpayers began using the election to opt out of the state-specific rules.

Although the memo doesn't mention it, Kranz and Smith represent some of those same multistate business taxpayers. They have clients in Michigan, Minnesota, and Oregon who are seeking refund claims under the compact election. "The Article III election is really a pivotal point of the compact because it allows for sovereignty but then provides the safety valve for multistate taxpayers who desire uniformity and ease of compliance," Smith said.

Kranz and Smith said they encouraged lawmakers to understand the threat posed by *Gillette* and evaluate what they should do to address it. "We didn't give them an answer," Kranz said. "We didn't say you need to withdraw [from the compact], that that's the right decision for you. We raised the questions, and it's up to them as policymakers to decide what the right course of action is for their given state."

The NCSL task force agreed to transmit the memo to lawmakers in compact member states. That might be particularly noteworthy, given the influence task force members have in their states when it comes to membership in the Multistate Tax Compact. Half of all Multistate Tax Compact legislation enacted this year was sponsored by NCSL task force members: Utah Sen. Wayne A. Harper (R), South Dakota Sen. Deb Peters (R), and Minnesota Sen. Ann Rest (DFL).

Another member of the task force, Utah Sen. Curtis Bramble (R), on August 15 took office as the NCSL's vice president and will become president in 2015. Bramble was one of the designated spokespersons who delivered the message to the Uniform Law Commission that it could face an effort to defund its operations if it proceeded with a project to revise UDITPA. He told Tax Analysts last year that lawmakers were nearing that same point with the MTC. (Prior coverage: *State Tax Notes*, Dec. 17, 2012, p. 871.)

"To have a president of the NCSL who understands state tax and engages in state tax policy discussion not just on behalf of Utah but on behalf of the legislative world is a great thing," Kranz said. "It will be a very positive thing to have him at the helm of the organization."

Pushing Buttons

Kranz's memo, peppered with references to threats to state sovereignty and a state's control over its corporate income tax apportionment rules and definitions, comes at a time when lawmakers guard their single-sales-factor apportionment formulas as a form of cutting-edge tax competition.

In addition to describing the legal theory behind *Gillette* and a compact member state's potential exposure to Article III litigation, Kranz lists two areas that could give rise to spinoff lawsuits. The first is in those states that repeal the compact from their codes and then reenact versions without the Article III election provision or Article IV apportionment formula, he said.

In the memo, Kranz asked how a compact member can avoid application of the Article III election. He warned that the validity of a state's repealing and reenacting a version of the compact without the Article III election may not be upheld if taxpayers prevail in *Gillette*, because the election into the

compact's apportionment rules is an all-or-nothing proposition. "The only failsafe method for a Compact Member is to withdraw from the Compact itself," Kranz wrote.

MTC General Counsel Shirley Sicilian recently explained the reasoning behind the repeal/reenact maneuver, saying that once a state is out of the compact, "it can start again with a clean slate" by adopting a modified version. That's partly so because of the flexible suggested enabling statute and partly because the Multistate Tax Compact is a model compact, she said. (Prior coverage: *State Tax Notes*, Aug. 19, 2013, p. 471.)

"I don't understand the concept that this is a model compact," Smith said, adding that, generally, model compacts are created by organizations that are trying to help states enter into binding compacts. It's not that the compact itself is model legislation, she said, adding, "Once it gets passed, it's no longer a model — it's actually a compact."

Kranz asked whether states that have repealed and reenacted modified compacts will continue to be seen as legal members of the original compact. If so, taxpayers would be entitled to the same election allowed by the original compact, he said.

"The modification of the compact will likely lead to Round Two litigation over the same question: Is the compact in its entirety binding?" Kranz said. He added that those cases will arise as taxpayers decide whether to take the election on future tax returns.

In the memo, Kranz wrote that another potential source of litigation could arise from the MTC's adoption of its proposed amendments to Article IV.

> ***'The modification of the compact will likely lead to Round Two litigation over the same question: Is the compact in its entirety binding?' Kranz said.***

Kranz wrote that if the MTC adopts the proposed amendments to UDITPA/Article IV, litigation could result over whether taxpayers are entitled to the benefit of the amended compact even if the changes are not adopted by a compact member's state legislature. Put another way, Kranz wrote that subsequent amendments to the compact might be binding to compact members even if a compact member's legislature chooses not to adopt the amendments. He pointed out that compact member states might risk having pending amendments to the compact imposed on them to maintain their membership status.

The memo says that if the Multistate Tax Compact is not binding on member states, many in the taxpaying community believe the MTC lacks the legal authority to conduct audits on behalf of those states that are not members. "Thus, Compact members may be faced with choosing between accepting control over part of their corporate income tax imposition or losing the revenue from the Commission's multistate tax audits," Kranz wrote. (Prior coverage: *State Tax Notes*, July 8, 2013, p. 67.)

There will always be tension between the auditor and the businesses being audited, and there's no doubt that to the extent the MTC is less effective, that would benefit Kranz and Smith's clients.

But Kranz and Smith said their focus is not on the MTC's audit program but on what it means for a state to be a compact member and whether there is an appropriate role for members to develop uniform legislation that affects policy issues.

Nature of the Compact

Kranz and Smith said questions raised by 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. Smith criticized the lack of public discussion at MTC meetings about the nature of the compact as an organizational document.

"To me that really was a question that needed to be addressed before they got into the UDITPA rewrite, before they started down the path of amicus in the *Gillette* litigation," Smith said. "I think it would have been useful for the public and corporate taxpayers to have at least heard those types of issues aired and discussed."

Sicilian has made a distinction between kinds of compacts, saying the Multistate Tax Compact is not the kind of compact the taxpayers in *Gillette* argue it is. Sicilian said the U.S. Supreme Court in *U.S. Steel v. Multistate Tax Commission*, 434 U.S. 452, 473 (1978), found only that the compact did not require congressional approval to be valid, not that it is binding.

Smith agreed that the Court in *U.S. Steel* was silent on whether the Multistate Tax Compact is binding. However, the Court and apparently all parties to the litigation assumed at the time that the compact was binding, "because if it wasn't a binding compact, the compact clause itself never would have come into play," she said.

Sicilian has said that 80 percent of the compact cases cited in the court of appeal briefs in *Gillette* deal with congressionally approved compacts, which the Multistate Tax Compact is not. But Smith countered that the reason 80 percent of the compacts cited in the litigation are congressionally approved is because most state compacts have received federal approval.

Sicilian also has said the remaining cases cited in the briefs deal with compacts that require reciprocal action to be effective, which she said does not apply to the Multistate Tax Compact.

Smith disagreed and pointed to Article X, which states that the Multistate Tax Compact shall enter

into force when enacted into law by any seven states. "I think that in itself is sufficient reciprocal action, because it's basically saying it's not binding until seven states agree to be bound by it," she said. "If only four states had passed it, there would be no compact."

In *Gillette*, the California Court of Appeal characterized the compact as binding. It quoted *Seattle Master Builders v. Pacific N.W. Elec. Power*, 786 F.2d 1359 (9th Cir. 1986), which it said summarized the U.S. Supreme Court's primary indicia of a compact: the establishment of a joint organization for regulatory purposes; conditional consent by member states in which each state is not free to modify or repeal its participation unilaterally; and state enactments that require reciprocal action for their effectiveness.

But Sicilian has argued that the Multistate Tax Compact meets none of those requirements. She has said the MTC has no regulatory authority over compact members, that the compact allows a state to repeal and withdraw, and that the compact does not require reciprocal action to be effective. In support, she cited *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), in which the U.S. Supreme Court accepted as constitutional Iowa's single-sales-factor apportionment formula, even though the three-factor, equal-weighted formula was the recognized benchmark at the time.

But Smith said the U.S. Supreme Court cases that *Seattle Master Builders* relied on make clear that an organization established by a compact for regulatory purposes doesn't need to promulgate binding regulations. Instead, the joint organization can be established for the purpose of helping states coordinate a specific industry, such as licensing, she said.

Smith said it's important to note that *Gillette* differs from some of the compact litigation cited by Sicilian in that a state isn't taking the position that another state has violated the compact. In *Gillette*, a third-party beneficiary — the corporate taxpayer — is asserting that the compact needs to be enforced as written. A compact is a contract, and under standard contract law, if there's an intended third-party beneficiary, the third party has standing to enforce the contract and thus has standing to enforce the compact, Smith said.

MTC's Future

Kranz and Smith said there is an appropriate way for the compact member states to develop uniform legislation. However, they said the MTC should focus more on developing legislative models that would aid taxpayer compliance on administrative matters made complex and burdensome because of tremendous variation across the states, such as on state definitions and filing deadlines associated with the IRS's issuance of a final revenue agent's report for settled federal audits.

"UDITPA is loaded with policy questions and [has] caused a fight for years now whether it should be rewritten or not," Kranz said. "Those are the kinds of issues we don't think the MTC should be tackling."

***Kranz and Smith said the MTC will survive* Gillette.**

Kranz and Smith said the MTC will survive *Gillette*. "We have no doubt that the organization will continue if in fact they lose in *Gillette* and their progeny," Kranz said. But he pointed out one upshot of the litigation is that the MTC will have to address the governance structure and organizational issues that he and Smith have been raising since their time at the Council On State Taxation more than a decade ago.

Smith elaborated, saying that as a tax lawyer, the question of how an entity is structured is fundamental, yet difficult to pin down. "What is the Multistate Tax Commission?" she asked. "If they're not a government compact, what are they?"

Kranz said the MTC plays some roles today that it will continue to play, no matter whether it is a governmental or 501(c) organization. "They will evolve if they need to, no question about that," he said. "The litigation will ultimately decide whether they have to evolve or not." ☆