taxanalysts viewpoint

# 200 Years of Interstate Cooperation: Could a State Tax Case Be the End?

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*So be careful what you wish for*
*'Cause you just might get it*
*And if you get it then you just might not know*
*What to do wit' it, 'cause it might just*
*Come back on you tenfold*

— Eminem
"Be Careful What You Wish For"

## Introduction

Imagine picking up a newspaper and reading that Nevada will be erecting an oil rig in the middle of pristine Lake Tahoe, New York will begin charging higher tolls for cars with New Jersey license plates to take the Lincoln Tunnel, and states will be unilaterally deciding that any detained prisoner will not be turned over to California authorities for prosecution of crimes committed in California. Of course, none of that can happen today because these states have entered into interstate compacts preventing them from unilaterally effectuating such actions. That might all change, however, because of a state tax case. For state tax practitioners, the impending California Supreme Court decision in *Gillette v. Franchise Tax Board*[1] may be the most significant state and local tax decision to be rendered since the U.S. Supreme Court's landmark 1992 ruling in *Quill v. North Dakota*.[2] At issue in *Gillette*, however, is much more than a state tax matter. The decision will have ramifications for the over 200 existing interstate compacts addressing matters as wide-ranging as environmental control of Lake Tahoe to interstate transfers of violent criminals.[3]

The issue before the California Supreme Court is whether the Multistate Tax Compact affords its members the flexibility to deviate from a core tenet of the interstate agreement: the election under Article III to apportion income under the compact formula or the state's own apportionment formula. The Franchise Tax Board and the administrative agency for the compact, the Multistate Tax Commission, interpret the compact's terms to allow for that flexibility, which they assert California unilaterally exercised in 1993 when it amended its apportionment statute to require most California taxpayers to exclusively use a double-weighted sales factor apportionment formula. According to the FTB and the commission, the compact is to be "liberally construed" and not designed to lock its members into a system in which no one member could make changes without all members doing the same. The FTB and the commission assert that the purpose of the compact is to "promote," not guarantee, uniformity, and to preserve state sovereignty regarding policy choices such as factor weighting and elections. To the extent that the FTB and the commission recognize any limitations on the compact's flexibility, they believe it is the members themselves who make that evaluation, apparently without any need to legislatively amend compact terms.[4]

The taxpayer, on the other hand, claims that a fundamental principle of compact law is that states cannot unilaterally amend compact provisions piecemeal. The taxpayer finds no basis in the law or facts to interpret the compact's provisions to allow a unilateral deviation from the election provision. According to the taxpayer, the express terms and stated purposes of the compact, as well as compact

[1]209 Cal. App. 4th 938 (2012).
[2]504 U.S. 298 (1992).

[3]For a comprehensive look at the more than 200 interstate compacts, see http://apps.csg.org/ncic/.
[4]Brief of the Multistate Tax Commission as amicus curiae, at 8.

law itself, direct that all the compact's terms, including the election to apportion, are binding on member states. Also, the taxpayer claims it is not within the commission's authority to sanction the conduct of states when interpreting compact provisions. With regard to the FTB and the commission's stance on uniformity, the taxpayer notes that promoting uniformity is at the core of the compact. Although the compact does not promise uniformity in all phases of state taxation, it does promise that a uniform apportionment formula will be available to electing taxpayers in member states.

For those of us in the state tax world, matters of compact law may not be a subject with which we are very familiar. What are interstate compacts, how much leeway do states have regarding the compacts they have entered, and have the courts addressed the question of a later-enacted conflicting state statutory provision? Since the position advanced by the FTB and the commission in *Gillette* would likely have a significant effect on many of today's multistate agreements if adopted, it may serve us well to have a better understanding of interstate compacts.

### What Are Interstate Compacts?

Compacts have been in existence since the country's founding as a way to resolve or prevent disputes between colonies. What has changed since those early days is the increased sophistication and reach of these agreements.[5] Although there are many types of interstate compacts, applying to issues ranging from conservation and resource management to civil defense, emergency management, law enforcement, education, energy, mental health, workers' compensation, transportation, and taxes, they generally fit into three broad categories:

- border compacts — agreements between states that establish state boundaries;
- advisory compacts — agreements between states that create study commissions that examine problems facing those states; and
- regulatory compacts — agreements between states that create administrative agencies whose rules and regulations may be binding on the states.[6]

From the late 1700s to the early 1900s, states entered into 36 compacts, most of which were border compacts.[7] As compacts became more common, they grew in sophistication, starting in the early part of the 20th century with the creation of advisory compacts. Although advisory agreements reflected an evolution in interstate compacts, they lacked any formal governance structure or enforcement procedures, prompting yet another shift in the sophistication of interstate compacts: the creation of regulatory compacts. The Port Authority of New York and New Jersey is one of the most well-known interstate regulatory compacts. Created in 1921, the Port Authority conceives, builds, operates, and maintains infrastructure critical to the New York and New Jersey region's trade and transportation network. Those facilities include airports, marine terminals and ports, and rail and bus systems, as well as the tunnels and bridges between New York and New Jersey. This compact supports hundreds of thousands of jobs and billions of dollars in economic activity.[8]

The Multistate Tax Compact is also a regulatory compact that gives the commission advisory capacity to recommend uniformity provisions, which each member has the power to reject, disregard, amend, or modify. The Multistate Tax Compact also provides authority to the commission to conduct joint audits, if a party state so chooses.[9]

### Compacts Are Both Statutes and Contracts

Compacts, such as the Port Authority and Multistate Tax Compact, are enacted into law by state legislatures. Each member state, in essence, adopts a reciprocal law. Since compacts are statutory, the legal principles that apply to the interpretation of statutes also apply to the interpretation of compacts. The analysis, however, does not stop there. In addition to being statutory, interstate compacts are also binding contracts that create an agreement among states, such as providing disaster aid from the devastation caused by hurricanes. Although perhaps not as dramatic as a hurricane, taxation and the creation of multistate agencies to address policy matters may also be subject to an interstate compact. In fact, writing for the *Yale Law Journal* in 1925, soon-to-be-appointed Supreme Court Justice Felix Frankfurter wrote:

> Certainly as between the States there is much need for simplification, for avoidance of litigation, for equitable apportionment of common taxing resources, which, to some extent, may affect the total of taxation and the inconveniences incident to the administration of our tax laws. . . . At all events, in view of the growing burden upon time and feelings, as well as the cost in money due to the conflicts and confusion arising from the administration of independent systems of State taxation, the

[5]Council of State Governments: Interstate Compacts Background and History, Mar. 2011.

[6]"Understanding Interstate Compacts,"

[7]Council of State Governments: National Center for Interstate Compacts — Compacts as a Tool of the Game.

[8]http://www.panynj.gov/.

[9]Multistate Tax Compact Article VIII, *U.S. Steel v. Multistate Tax Commission*, 434 U.S. 452 (1978).

possibilities of amelioration and economy realizable through an alert use of the Compact Clause call for more intensive study, as part of a disciplined attack upon the entire tax problem.[10]

Since compacts are considered contracts within the meaning of the Constitution, states are prohibited from passing a law that impairs this obligation.[11] That constraint is one important difference, for example, from a uniform state law. A uniform state law does not depend on a contractual agreement. Thus, a state can change a portion of its law but still adhere to the underlying principle of uniformity. In stark contrast, since interstate compacts are enforceable obligations among members, their terms and conditions take precedence over the unilateral actions and statutes of member states.[12]

### What Are the Advantages of Compacts?

One advantage of enacting an interstate compact is the ability to draft the agreement to adapt to changing conditions. Contrast that with litigation, in which the resolution of an issue is static and does not lend itself to accommodate continuously competing interests.

An additional critical advantage to interstate compacts is that they permit states to maintain their sovereignty by allowing them to act collectively without federal government interference. Indeed, the genesis of the Multistate Tax Compact was an interest in creating a state-level response to the federal concerns about the confusing rules and regulations that governed the taxation of businesses operating in interstate commerce. With congressional committees recommending federal legislation to establish a uniform state income tax base and apportionment formula, the response to that looming federal intervention in states' rights to tax was the creation of the Multistate Tax Compact. An advantage of the compact is that each member state retains "complete control over all legislation and administrative action affecting the rate of tax [and] the composition of the tax base."[13] As with almost all compacts, the Multistate Tax Compact allows a state to retain complete sovereignty. There is a simple solution for a later legislature that no longer wants to abide by the compact mandates: enacting a statute withdrawing from the compact.[14]

### The Supremacy of an Interstate Compact

As noted, compacts have all the characteristics of a contract. An offer is made when one state enacts by statute the terms of a compact that requires approval by another state or states to become effective. That offer is then accepted through the enactment of the same compact terms by other states. Once the required number of states adopts those provisions into their laws, the contract among them becomes valid.[15] That is what happened with the Multistate Tax Compact when in 1967 the required minimum of seven states enacted it.

***When a compact is enacted, its provisions take precedence over the later statutes of signatory states.***

The contract clause of the U.S. Constitution protects compacts from impairment by the states, as it does with other contracts. Thus, when a compact is enacted, its provisions take precedence over the later statutes of signatory states and, as such, a state may not unilaterally amend a provision if the compact does not so provide.[16] A legislature may not override the compact without running afoul of the Constitution.[17]

The consequences of ruling otherwise would be disastrous to the U.S. economy by impeding interstate commerce, endangering public safety, and creating environmental harm. Imagine, for example, an interstate compact to control pollution along the Ohio River. Each state enacts into law provisions that pledge cooperation in maintaining the river waters in a sanitary condition. Any sewage discharge into the river flowing from one state into

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[10] "The Compact Clause of the Constitution — A Study in Interstate Adjustments," *Yale Law Journal*, Vol. XXXIV, p. 704, May 1925.

[11] *Green v. Biddle*, 21 U.S. 1 (1823). The compact between Virginia and Kentucky on separation of the latter from the former state could not be avoided by Kentucky after the compact had been acceded to by the people in their sovereign capacity, even though the compact might be inconvenient or even pernicious to the state. The constitutional prohibition against impairing contracts embraces all contracts, whether between individuals or states, and under it a state has no more power to impair an obligation into which it has entered than to impair an obligation of individuals.

[12] *Hellmuth v. Washington Metropolitan Area Transit Authority* 414 F. Supp. 408 (1976). See, also "Understanding Interstate Compacts," *supra* note 6.

[13] *U.S. Steel, supra* note 9.

[14] *See, e.g.*, South Dakota SB 239, which would repeal all provisions of the Multistate Tax Compact from South Dakota law. Also, Utah introduced SB 247, which would repeal and then reenact some compact provisions. See also, Herbert and Mayster, "The Multistate Tax Compact — A Promise Forgotten," *State Tax Notes*, Nov. 19, 2012, p. 597.

[15] "Compacts as a Tool of the Game," *supra* note 7.

[16] *Aveline v. Pennsylvania Board of Probation* (729 A.2d 1254, 1999).

[17] *Doe v. Ward*, 124 F. Supp.900, 914-915 (WC Pa, 2000) — "As with other contracts, the Contract Clause of the United States Constitution protects compacts from impairment by the states."

another must be treated to protect the public health. Clearly that interstate compact provides a regional solution to a public concern without the need for federal intervention. One may ask, however, once the compact is enacted, what is to prevent one member state's legislature from later declaring membership invalid as an improper delegation of police powers to other states, thus potentially allowing the state to pollute the river waters? The U.S. Supreme Court addressed that fact pattern and held that a compact is a legal document among states and that one state cannot be its own ultimate judge in a controversy with a sister state. The Court found nothing to prevent states from entering into an interstate compact to control river pollution and said that by doing so, each state has "bound itself to control pollution by the more effective means of an agreement with other states."[18]

As noted above, New York and New Jersey have a special need for the Port Authority. At the time of its creation, half of the nation's foreign commerce passed through the port, which is split between the legal jurisdictions of both states. The complexities of creating efficient and continuous movement of commerce, regulating traffic on the water and over the bridges and roads, monitoring the engineering needs of the harbor, and ensuring an adequate supply of terminals in both New York and New Jersey meant that for success to be realized, a coordinated effort was required.

***The commission's and the FTB's interpretation of compacts would undermine interstate cooperation.***

Imagine a simple change to a minor aspect of that vast agreement: New York decides to no longer abide by the provisions of the Port Authority and implements a surcharge to the toll on cars entering the state bearing New Jersey license plates. That simple example is intended only to illustrate the effect of a state unilaterally ignoring a compact provision. If New York could ignore a minor, noncritical provision of the Port Authority agreement, it would be difficult to determine what other provisions it could likewise ignore, creating the potential for significant economic disruption to nationally vital interests.

When one thinks of the considerable role of compacts in the day-to-day governance of commerce, natural resources, the environment, education, corrections, public safety, transportation, and so on, it quickly becomes apparent how the commission's and the FTB's interpretation of compacts could result in repercussions not contemplated throughout the over 200 years of compact history. The commission's and the FTB's interpretation of compacts would undermine interstate cooperation and may well result in increased disputes among member states of any compact. A disciplined reading of a compact's provisions, on the other hand, provides the manifold advantages of clearly defined operational standards for party states.

### The Multistate Tax Compact: What Do Its Provisions Permit Member States to Do?

As we've shown, with so much at stake, with such a broad range of national and interstate conflicts and issues addressed, basic compact principles mandate clearly defined standards for the administration of these agreements. The FTB and the commission argue that the compact terms "suggest" that its members have the flexibility to vary from its provisions and that the compact was not designed to "lock its members into a system where no member could make changes without all members doing the same."[19] That interpretation, according to the FTB and the commission, is supported by the "course of performance" of other compact members, none of which have objected to California's interpretation that precludes taxpayers from exercising the Article III election.

The FTB and the commission cite the course of performance of member states as providing the authority to recognize California's 1993 legislation as consistent with the compact.[20] Nowhere within the compact is authority granted to the commission to sanction through a simple resolution a state's unilateral departure from the Article III election. Nowhere in the compact is there language stating that a unilateral departure from an article may be authorized by negative implication — that is, that no member objects. Imagine the potentially devastating ramifications of that authority. If the mere casual approval by member states is sufficient to allow unilateral departure from Article III, what happens if next year a single state decides to object? Will there be retroactive denial of California's 1993 actions?

The commission distinguishes the Multistate Tax Compact from other interstate compacts, such as the Port Authority, saying that the provisions of those agreements are "critical for the proper function" of those compacts. From a legal perspective, a court will ultimately decide if that interpretation abides

[18] *See Dyer v. Sims*, 341 U.S. 22 (1951).

[19] *Supra* note 4.

[20] The FTB notes in its petition for review before the California Supreme Court that before California joined the compact, the member states and the commission passed a unanimous "resolution" affirming Florida's unilateral repeal of the election and also confirmed that Florida remained a member in good standing. Petition filed Nov. 13, 2012, p. 9.

by compact law and the federal and state constitutions. From a practical perspective, however, one has to ask whether drawing such a fine line between compact provisions that are "critical" and those that are merely "suggestions" will advance issues of governance and administration of interstate compacts.

Interstate compacts have been drafted and enacted since the 18th century. Since then, federal and state courts have consistently ruled that states may not unilaterally amend a provision if the compact does not so provide. The only exception to that bedrock principle of compact law is when the compact itself provides that a member state may disregard a provision. For example, the drafters of the Multistate Tax Compact provided for party states to choose whether to participate in the joint interstate audit program — the compact language states that those activities will be permissible only if a party state "specifically provide[s] therefore by statute."[21] That is the only provision in the compact that states can choose to not follow. All other compact provisions are mandatory and binding until a state withdraws from the compact or the member states collectively reenact a new version of the compact.

The idea of a Multistate Tax Compact was brought forward by then-Assistant Attorney General of Michigan William David Dexter. He argued the *U.S. Steel* case in the U.S. Supreme Court, which upheld the constitutionality of the compact. At the time Michigan joined the compact, it was also a member of three other non-congressionally approved compacts, including a critical boundary compact with Minnesota and Wisconsin, a civil defense compact, and a transportation compact. It is hard to imagine that Dexter would have thought Article III of the Multistate Tax Compact wasn't binding on the states, because reliance on following the provisions of those other interstate agreements would be critical for the safety of Michigan's citizens and Michigan's economy.[22]

## Conclusion

Interstate compacts are powerful tools that afford states the ability to address a wide variety of questions of regional and national importance without the need for federal intervention. Given the significance of those agreements, as well as the diversity of problems and challenges they address, it is readily apparent that any decision affecting the Multistate Tax Compact will reach well beyond the state tax realm. ☆

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[21]Multistate Tax Compact, Article VIII.

[22]Michael Herbert, Bryan Mayster, and Michael Santoro, "States Weighing Considerations for Continued Multistate Tax Compact Membership."