

The impact of multistate tax compact withdrawals on the joint audit program

June 6, 2013

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There is nothing more deceptive than an obvious fact.

- Arthur Conan Doyle

Introduction

The infamous Greenbrier Hotel is an award winning luxury resort with a long storied history. Located in the Allegheny Mountains of West Virginia, the resort was a center of post-Civil War society. During World War II, the resort served both as an army hospital and as an internment facility for Japanese, Italian and German diplomats. In the late 1950s, a uniquely ambitious and secretive project took place at the Greenbrier. The US government approached the hotel owners and asked for assistance in creating a secret emergency relocation center to house Congress in the aftermath

of a nuclear attack. The classified, underground facility was discretely built at the same time as an above-ground addition to the hotel. Rumor has it that even the spouses of the construction workers didn't know of the stealth project. For over thirty years, with thousands of guests staying at the Greenbrier, no one who visited the hotel even knew of the underground facility's existence, yet it was large enough to house all members of Congress for an extended period of time. The secret location stayed hidden until the early 1990s when a Washington Post reporter revealed the existence of "Congress' bunker" after extensive research into the late

1950s hotel expansion.¹ The concept behind the now declassified facility was simple: people don't notice the most obvious of things.

At the same time the bunker was being built in West Virginia, the Uniform Division for Income Tax Purposes Act (UDITPA) was being drafted by the National Conference of Commissioners on Uniform State Laws.² A few years later, when the Multistate Tax Compact (Compact) became effective, it adopted UDITPA as Article IV. Recently, a number of states have withdrawn from the Multistate Tax Compact. South Dakota withdrew in March.³ In April, Utah

¹ <http://www.washingtonpost.com/wp-srv/local/daily/july/25/brier1.htm>

² UDITPA was approved at the 66th Annual Conference of the National Conference of Commissioners on Uniform State Laws in July, 1957.

³ South Dakota SB 239

Utah withdrew from the Compact but temporarily re-enacted the Compact with the exception of Article III, the apportionment election provision, and Article IV, the UDITPA provision.⁴ In May, Minnesota withdrew from the Compact, but simultaneously enacted a provision giving the commissioner the power to authorize participation in audits performed by the Multistate Tax Commission.⁵ At the time of this writing, the Oregon legislature has passed a bill that would withdraw the state from the Compact and the bill is now before the Governor.⁶

With these recent state withdrawals from the Multistate Tax Compact, a number of issues arise, including the impact they will have on the joint audit program authorized under Article VIII of the Compact. Will the states that have repealed the Compact but re-enacted all provisions except for Articles III and IV still be considered “members” of the Compact and be able to continue to participate in the joint audit program? What about the states that repeal the Compact but legislatively provide the tax commissioner with the authority to participate in the joint audit program? Does it even matter whether states are “members” of the Compact? A careful review of the plain language found in Articles VI and VIII (described below) may reveal something not noticed about the limitations the Compact places on the joint audit program. To recognize these limitations, however, one must understand the permissible functions, powers and duties of the Multistate Tax Commission as established under interstate compact law.

Interstate Compact Agreements – Compact Governance

Interstate compacts are formal agreements among states that have both statutory and contractual aspects. Since compacts are statutes enacted by state legislatures, the entire body of legal principles applicable to statutory interpretation apply. In addition, compacts are contractual because of the manner in which they are adopted. A violation of compact terms, like a breach of contract, is subject to judicial review.⁷

State legislators may enter into interstate compacts and delegate to an administrative body the power to make rules, establish committees, study systems, compile and publish information, audit and perform other clearly delineated functions. In 1951, the US Supreme Court in *Dyer v. Sims* upheld states’ power to create interstate commissions through the adoption of an interstate compact.⁸ Notably, the Court recognized the need for “a carefully limited delegation of power to an interstate agency.”⁹ That is because, in part, the more authority an administrative body has, the greater the potential danger that may result from the diminished ability of the party states to govern the very agency they created. This concern is particularly true because of the difficulty in amending compact terms by all party states. Thus, it is essential that the powers vested in an administrative body be clearly defined and carefully followed. This may be why, for example, compact terms often provide for the issuance of reports to the state

legislatures and governors covering activities for the preceding year. Modern compacts place a great deal of attention on the governing provisions.¹⁰

The Multistate Tax Compact

In *United States Steel Corp. v. Multistate Tax Commission* the US Supreme Court held the Multistate Tax Compact is a valid and binding interstate compact between signatory states.¹¹ The Compact became effective, according to its own terms, in 1967 after seven states had adopted it. Article VI of the Compact creates the Multistate Tax Commission (the Commission), composed of tax administrators from all the member states. There are a number of sections within the Compact that clearly define the functions and powers granted to the Commission.

Article VI, Section 3 authorizes the Commission to:

(a) study state and local tax systems and particular types of state and local taxes; (b) develop and recommend proposals for an increase in uniformity or compatibility of state and local tax laws with a view toward encouraging the simplification and improvement of state and local tax law and administration; (c) compile and publish information as in its judgment would assist the party states in implementation of the Compact and taxpayers in complying with state and local tax laws; and (d) do all things necessary and incidental to the administration of its functions pursuant to this Compact.

⁴ Utah SB 247

⁵ Minnesota HF 677

⁶ Oregon SB 307

⁷ See the National Center for Interstate Compacts’ website at <http://www.csg.org/ncic/> for more information on interstate compacts.

⁸ *Dyer v. Sims*, 341 US 22 (1951).

⁹ *Id.* at 30.

¹⁰ <http://www.csg.org/knowledgecenter/docs/ncic/Success.pdf>

¹¹ *United States Steel Corp. v. Multistate Tax Commission*, 434 US 452 (1978).

Article VII addresses the Commission's powers related to uniform administrative regulations and forms.

Article VIII applies only in those states that specifically adopt it by statute. The Article authorizes "any party state" to request that the Commission perform an audit on its behalf:

Any party state or subdivision thereof desiring to make or participate in an audit of any accounts, books, paper, records or other documents may request the commission to perform the audit on its behalf. . . The commission may enter into agreements with party states or their subdivisions for assistance in performance of the audit. . .

Information obtained by any audit pursuant to this article shall be confidential and available only for tax purposes to party states, their subdivisions or the United States.

Availability of information shall be in accordance with the laws of the States or subdivisions on whose account the commission performs the audit, and only through the appropriate agencies or officers of such States or subdivisions. Nothing in the Article shall be construed to require any taxpayer to keep records for any period not otherwise required by law.

As the US Supreme Court in *Dyer* suggested, the Compact language should be considered a carefully limited delegation of authority. Thus Articles VI, VII and VIII appear to establish the universe of functions and powers delegated to the Commission.

Under principles of interstate compact law, the Multistate Tax Compact does not provide its administrative agency, the Commission, with any additional authority.

Current Commission Practice for Interstate Audits

The Commission engages in interstate audits of member states, sovereignty members, and associate and project members, including states that have merely statutorily granted authority to enter into a contract to participate in the audit program.¹² The Commission's audit committee, which is comprised of representatives from each state (including non-party states) that participates in the joint audit program, is responsible for choosing audit targets.¹³ The Commission's audit staff performs audits "as though they were part of a state's own audit staff, forwarding their findings and recommendations to the member states for assessment and collection at the completion of the audit."¹⁴ The Commission website describes how the Audit Program works and its benefits and goals. The website has links to documents describing the Audit Selection Process, the Sales Tax Joint Audit Process, and the Income Tax Joint Audit Process. The website also indicates that "the information presented in the Audit Program web pages is also available for downloading or printing" in a document called the "[Report on the MTC Joint Audit Program](#)." There is a page dedicated to explaining how taxpayers can request a joint audit.

The site also has pages on The Audit Committee as well as Training Programs and Resource Documents, including the audit manuals for income tax and sales tax. There is extensive documentation on Statistical Sampling as well.¹⁵

States decide whether or not to participate in a given audit and how to address the audit findings. The information obtained during these audits, as provided under Article VIII, is confidential but made available to member and participating states. In addition, states may share with the Commission information obtained from their separate audits.¹⁶

Two of the issues taxpayers seem to be most concerned with are the 51 state spreadsheet requested in Commission audits and that the states do not have to accept the Commission audit findings often resulting in further audit procedures by the individual states.

In What States May the Commission Audit and Share Information?

Party States

As noted above, the Compact gives the Commission authority to audit and share information with any "party state or subdivision thereof." Nothing within the Compact provides the Commission with authority to audit or share information other than with party states. What is a "party state?" While the term is used forty nine times throughout the Compact, no definition is provided.¹⁷

¹² See e.g., Wisconsin Sec. 73.03 (28d). It shall be the duty of the department of revenue, and it shall have the power and authority: To enter into a contract to participate in the multistate tax commission audit program. See also, Minnesota HF 677. Sec. 270C.03, sub. 1. The commissioner shall have and exercise the following powers and duties: (9) authorize the participation in audits performed by the Multistate Tax Commission. For the purposes of chapter 270B, the Multistate Tax Commission will be considered to be a state for the purposes of auditing corporate sales, excise and income tax returns.

¹³ See appendix for a list of states that participate in the joint audit program.

¹⁴ See www.mtc.gov for information on the MTC audit program.

¹⁵ See <http://www.mtc.gov/Audit.aspx?id=578>

¹⁶ See, e.g., Oregon Sec. 314.840(2): *The Department may disclose and give access to information described in ORS 314.835 to . . . (d) The Multistate Tax Commission or its authorized representatives, for tax administration and compliance purposes only.*

¹⁷ In its Public Participation Policy document, the Commission defines "member state" as "a party State of the Multistate Tax Compact, an associate or sovereignty member State of the Commission or any State participating in a Commission program."

Since the Compact is a statute, the definition of “party state” may be determined using statutory analysis of its plain meaning and legislative intent. The legal analysis of the meaning of “party state” will be left to taxpayers and their attorneys. However, guidance may be found by simply looking to Compact language. Article VI of the Compact provides: “The Multistate Tax Commission is hereby established. It shall be composed of one ‘member’ from each party state.”¹⁸ There does not appear to be anything unclear about the drafters’ intent. A literal reading of Article VI may lead reasonable persons to agree that party states are only those states that may have members on the Multistate Tax Commission. Bylaw 13 of the Commission states: “The Commission provides opportunities for sovereignty, associate, and project membership to those states that have not effectively enacted the Compact. . . . Sovereignty members are states that support the purposes of the Multistate Tax Compact and work with the Commission and its member states Representatives of sovereignty members . . . are not eligible to serve as an elected member of the Executive Committee.” The Compact and the bylaws clearly treat party member states differently than sovereignty and other member states. That is, party states are afforded more rights than other types of member states. At a minimum, this calls into question whether any state other than one that has effectively enacted the Compact may be considered a party state that can participate in a joint audit under Article VIII.

The confidentiality provisions of Article VIII are also clear: information sharing is limited to party states and only for tax purposes. Since information is currently shared with non-party states, one wonders about the consequences of joint audits that result in the sharing of taxpayer confidential information with these non-party states.¹⁹

Partial Re-Enactment States

What does it mean to “effectively enact the Compact?” Have states that have withdrawn from the Compact and re-enacted all its provisions except for Articles III and IV effectively enacted the Compact? May these states be considered party states? The Commission has informally indicated it will entertain treating these states as full members (party states) if the re-enactment of the Compact is in “substantially similar form” to other states, as stated in the Compact’s suggested enabling language.²⁰ What does it mean to be in “substantial similar form?” Can a state that enacts all Compact provisions except Articles III and IV be substantially similar to states that have adopted all provisions of the Compact?

Articles III and IV were critical to the adoption of the Compact and would therefore appear to be material and substantial provisions of the Compact.²¹ A brochure issued by the Commission in 1968 makes that clear, as the choice of using Article IV was the “promise” made. Indeed, it is because of these two provisions that states are legislatively withdrawing from the Compact. How can one

argue that these provisions are insubstantial? A plain understanding of what led to the Compact in the first place may lead one to conclude that adoption of a compact without Articles III and IV would not be substantially similar to complete adoption of the Compact.

States that Legislatively Provide Authority to Participate in the Joint Audit Program

What about the states that have merely provided for participation in the joint audit program by statute? Despite the states’ statutory authorization, how the Commission’s authority extends to the auditing of these states is unclear when one considers the grant of authority to the Commission as delineated in Articles VI, Section 3, Article VII and Article VIII. When read together, the Commission appears to have only one grant of audit authority, and that is to audit on behalf of “party” states. They are not granted any other powers by the Compact to audit for non-party states.

Conclusion

An interstate compact may delegate to an administrative body powers to address the common goals of its members. A compact itself establishes the parameters of that administrative body’s powers. The Multistate Tax Compact clearly defines the powers granted to the Multistate Tax Commission, including the right to conduct joint audits of party states. While party state is not defined, its usage within the Compact and bylaws appears to reference only full member states that have enacted the Compact.

¹⁸ The Commission’s Public Participation Policy, Section 2, distinguishes between party states and sovereignty, associate and participating states.

¹⁹ The Litigation Saga of Gilbert P. Hyatt v. State of California: An Update. State Tax Notes, May 27, 2013, p. 689, 68 State Tax Notes 689 (May 27, 2013).

²⁰ Utah Governor Signs Bill to Withdraw From Multistate Tax Compact. State Tax Notes, Amy Hamilton, April 4, 2013 Doc 2013-7956. Suggested Enabling Act, Section 1: The “Multistate Tax Compact” is hereby enacted into law and entered into with all jurisdictions legally joining therein, in the form substantially as follows . . .

²¹ See The Multistate Tax Compact -- A Promise Forgotten by Michael Herbert and Bryan Mayster for a discussion of Articles III and IV. 2012 STT 223-4.

As states withdraw from the Compact, one must ask whether the Commission has the authority to audit on behalf of these non-party states. Although the Commission may only

make audit recommendations to the individual states, it also may share confidential information obtained during the audit. If information sharing is limited to party states, at

issue are the consequences of the Commission sharing this information outside the boundaries of its stated powers.

Let's talk

To discuss how this issue might affect your business, please contact:

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Appendix

The following states participate in the respective audit programs.²² The highlighted states are non-party states.

State	Income Tax	Sales Tax
Alabama	X	X
Alaska	X	
Arkansas	X	X
Colorado	X	X
District of Columbia	X	X
Georgia		X
Hawaii	X	X
Idaho	X	X
Illinois	X	X
Kansas	X	X
Kentucky	X	X
Louisiana		X
Massachusetts	X	X
Michigan	X	X
Minnesota	X	X
Missouri	X	
Montana	X	
Nebraska	X	
New Jersey	X	X
New Mexico	X	
North Dakota	X	X
Oregon ²³	X	
South Carolina	X	X
Tennessee	X	X
Utah ²⁴	X	X
Washington		
West Virginia	X	
Wisconsin	X	X

²² As of June 1, 2013

²³ At the time of this writing, the Oregon legislature has approved legislation to withdraw from the Compact.

²⁴ Utah has withdrawn from the Compact and temporarily re-enacted all provisions except Articles III, IV and IX.