

The Journey of the MTC's Joint Audit Program

by Michael Herbert and Bryan Mayster

Michael Herbert is a partner and Bryan Mayster is a managing director in PricewaterhouseCoopers LLP's State and Local Tax practice. Herbert, who is based in San Francisco, assisted in filing the claims at issue in *Gillette v. Franchise Tax Board* before the California court, helped develop the issue for litigation, and worked with counsel on the case.

Losing your way on a journey is unfortunate. But, losing your reason for the journey is a fate more cruel.

— H.G. Wells

The history of the Multistate Tax Compact is the history of states' struggle to save their fiscal and political independence from federal encroachment.¹ In 1967, as Congress debated legislation to — in the name of uniformity — sharply curtail a state's jurisdiction to tax and dictate apportionment and allocation provisions, the Multistate Tax Commission issued a plea to states to work against forces that would “destroy the independence and right of decision of state tax administrators.”² The solution was a simple promise: We, the states, will enact a Multistate Tax Compact ensuring greater uniformity and efficiency if you, Congress, will refrain from further intervention into state tax sovereignty.

“The solutions of legitimate problems of interstate taxation lie in uniformity,” then-California Gov. Ronald Reagan said.³

By the end of 1968, 14 states had enacted the compact and become full MTC members. Another 12 states had become associate members.⁴ To entice

greater state participation, the commission released a brochure to the business community that highlighted the benefits of membership, including the Article III election to choose the Uniform Division of Income for Tax Purposes Act as a method of apportionment and the “advantage” of single audits by party states.

While the *Gillette v. Franchise Tax Board*⁵ litigation and similar cases wind their way through the courts addressing one forgotten promise⁶ — the election to choose a uniform apportionment method — we write today of a second forgotten promise, found in the 1968 brochure⁷: One audit for all states, which “allows the multistate taxpayer the advantage of having just one audit which can be used by *all party states* for tax purposes only.”⁸ These promises are premised on recognizing the compact as a valid interstate compact treated as a binding contract among member states.⁹

As the MTC was fighting to protect states' fiscal integrity from federal intrusion in its formative years, a driving philosophy was a single audit on behalf of party states in which taxpayers have the

states that had enacted the compact by legislation that was not yet effective or for states that formally requested associate membership. The commission hoped that associate membership would give states an opportunity to become familiar with its work and thereby be motivated to become parties to the compact.

⁵Calif. First Dist. Ct. App. Dkt. No. A-130803. (Oct. 2 decision; July 24 decision.)

⁶Michael Herbert and Bryan Mayster, “The Multistate Tax Compact — A Promise Forgotten,” *State Tax Notes*, Nov. 19, 2012, p. 597.

⁷MTC 1968 Brochure on the Multistate Tax Compact, *State Tax Notes*, Nov. 19, 2012, p. 600.

⁸Multistate Tax Commission Brochure at p. 9 (emphasis added).

⁹*See Green v. Biddle*, 21 U.S. 1 (1823). 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.

¹Multistate Tax Commission brochure, Apr. 1968.

²*Id.*

³*Id.*

⁴In October 1967, at its first legal meeting, the MTC adopted bylaws under the compact's authorization to do so. Bylaw 13 created a category of associate membership for

(Footnote continued in next column.)

option of employing a uniform apportionment method under uniform regulations.¹⁰ The commission describes the program as performing “‘joint’ tax audits on behalf of the states (a joint audit is one performed on a taxpayer on behalf of several states at the same time).”¹¹

In the view of many taxpayers, current MTC audit practices — particularly in states that refuse to provide an Article III election to employ a uniform apportionment method — are:

- inefficient because of lack of interstate uniformity and audits that are conducted by a single auditor who may not understand all the rules of the various states under examination;
- burdensome as the result of the unnecessary breadth of information requested, such as a 51-state spreadsheet;
- inequitable since the primary focus of audits appears to be revenue generation rather than arriving at the appropriate tax due; and
- arguably unauthorized because of the inclusion of nonparty states in audits and the sharing of confidential taxpayer information with those nonparty states.¹²

In this article we explore the journey of the MTC’s joint audit program in light of the commission’s early purpose of fighting for uniformity, efficiency, and compatibility of tax laws governing multistate businesses. Before we examine the MTC’s current audit practices, however, we first consider the early journey of the compact.

The Commission Touts the Success of Interstate Compacts

The MTC has been arguing that the agreement signed into law by member states is not a compact but a model law, and therefore, states can modify its

¹⁰Advantages to businesses touted in the 1968 brochure included:

Choice of Uniform Division of Income Act or state income tax allocation system . . . Businesses required to pay income tax in more than one state or subdivision can choose between the allocation methods of the Uniform Division of Income Act or those of the state or subdivision. [and]

One audit for all states . . . Allows the multistate taxpayer the advantage of having just one audit which can be used by all party states for tax purposes only.

¹¹Available at [http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/About_MTC/MTC_Compact/COMPACT\(1\).pdf](http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/About_MTC/MTC_Compact/COMPACT(1).pdf).

¹²The commission’s website contains annual reports for 1987-1988 and then skips to 1993-1994. The 1993-1994 Annual Report clearly shows non-party state participation in the audit program, while the 1987-1988 Annual Report shows Nebraska, a non-party state, as being on the Audit Committee.

provisions.¹³ Under this theory, the commission’s audit activity would not be limited to party states.

First, obvious to all is that the agreement is called a “compact,” even on the MTC website. Next, looking back at the 1968 brochure for a contemporaneous view of the compact by the commission, readers will note the other compacts the MTC sought to emulate. The brochure states the following, as the MTC attempted to persuade businesses to support the compact:

Compact agreements *do* work. For example:

- The Interstate Compact for the Supervision of Parolees and Probationers. Operates in all 50 states, the Commonwealth of Puerto Rico and the Virgin Islands.¹⁴
- The Interstate Civil Defense and Disaster Compact. Operates in all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands and Guam.
- The Vehicle Equipment Safety Compact. Enacted by 44 states and the District of Columbia.
- The Interstate Compact on Juveniles. In force in 42 states.
- The Compact for Education. Operates in 36 states, the Commonwealth of Puerto Rico, the Virgin Islands and American Samoa.
- The Interstate Compact to Conserve Oil and Gas. Operates in 30 states.

The Interstate Compact on Juveniles and the Interstate Compact to Conserve Oil are both congressionally approved compacts, while the others are not. Compacts with congressional approval are considered contracts and also federal laws that allow access to federal courts. Compacts that are not congressionally approved are binding contracts among the states. That is fundamental compact law.¹⁵

Because compacts are considered contracts, the Constitution prohibits states from passing a law that impairs this obligation.¹⁶ That constraint is one important difference, for example, from a uniform state law. A uniform state law, or model law, does not depend on a contractual agreement. Model laws are not binding, and a state can adopt any form of the

¹³The MTC website contains a PDF of the compact that asserts it is a model law. This PDF first appeared around October 2004 as *Gillette* was working its way through the California administrative process.

¹⁴Subsequently replaced by the Interstate Compact for Adult Offender Supervision.

¹⁵For a comprehensive look at the more than 200 interstate compacts, see <http://apps.csg.org/ncic/>.

¹⁶See *Green v. Biddle*, 21 U.S. 1 (1823).

model law it so chooses, in whole or in part. Compacts such as the Multistate Tax Compact, on the other hand, are binding on the signatory, party states.

A number of taxpayers have questioned why the commission has kept the historical draft and background documents (such as earlier drafts and memos) on the adoption of the MTC to itself, and has not, in a transparent way, made them available to the public. They wonder: Is it because these documents clearly show the member states knew the compact was intended to be and is a binding compact?

The MTC's Perspective on the Compact Question

Recently the MTC's general counsel was asked if the Multistate Tax Compact had the indicia of a compact as articulated in *Seattle Master Builders*: 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.¹⁷ While one may wonder if that question is necessary in light of *U.S. Steel*¹⁸ and the commission's 1968 brochure, some observations are warranted.

1. The Establishment of a Joint Organization for Regulatory Purposes

Regarding the issue of whether there is any regulatory authority vested in the body established by the compact, MTC General Counsel Shirley Sicilian said: "One thing we know for certain from *U.S. Steel* is the commission, while it is a body, it's not one that has any regulatory authority over the members."¹⁹

Others would point out that the commission does, however, regulate the activities of the powers granted under the compact. No administrative body established by an interstate compact has direct regulatory authority over its members; rather, it has regulatory authority over powers granted under the compact at issue. The regulatory authority that

exists for audits is limited to party states²⁰ under the plain language of the compact.

2. Conditional Consent by Member States

Regarding the directive that member states are not free to modify or repeal the compact, Sicilian said: "The compact explicitly allows for repeal, and whether or not states can modify [it] is the question here. We think they can."²¹

The historical documents clearly show that the states knew the compact was binding. That is why it is called a "compact" and references were made in the 1968 brochure to other compacts. Even the summary of the compact sent to the states in early 1967 was clear:

The Multistate Tax Compact provides that the Uniform Act will be available in all party States to any multistate taxpayer wishing to use it. Consequently, taxpayers will be able to have the benefits of uniformity whenever they want it. On the other hand, States adopting the compact reserve the right to enact any other laws dealing with allocation and apportionment of income that may seem to have a special appropriateness or to meet their own policies.²²

Thus, the commission in 1967 understood that while states are free to enact whatever apportionment scheme they wish, they are not free to modify the compact itself, including the Article III election.

3. Reciprocal Action

When asked if this is the type of compact that needs reciprocal action in order for it to be effective, Sicilian replied: "Emphatically not, and we know that from *Moorman*."²³

Moorman stands for the proposition that the states can enact whatever type of laws they want as their own state apportionment system, as just described. The reciprocal action of the states is clear from the history of the states' enactment of the compact when seven states adopted it under Article X,²⁴ which resulted in avoiding federal intervention in state taxation.

²⁰A discussion of the meaning of "party state," available at http://www.pwc.com/en_US/us/state-local-tax/newsletters/mysto/assets/pwc-impact-multistate-tax-compact-withdrawals.pdf.

²¹Hamilton, *supra* note 19.

²²Exhibit S, *Gillette* Answer Brief, California Supreme Court.

²³Hamilton, *supra* note 19.

²⁴Article X provides that the compact "shall enter into force when enacted into law by any seven States. Thereafter, this compact shall become effective as to any other State upon its enactment thereof. The Commission shall arrange for

¹⁷See *Seattle Master Builders v. Pacific N.W. Elec. Power*, (9th Cir. 1986), 786 F.2d 1359, 1363.

¹⁸In *United States Steel Corp. et al. v. Multistate Tax Commission et al.*, 434 U.S. 452 (1978), the U.S. Supreme Court held the Multistate Tax Compact is a valid compact even though it did not receive congressional approval.

¹⁹Amy Hamilton, "Compact Issues: Does the Multistate Compact Allow for State Variances?" *State Tax Notes*, Aug. 19, 2013, p. 471.

Sicilian went on to say that there is some question whether the Multistate Tax Compact is an interstate agreement more in the nature of a uniform law, at least regarding articles III and IV. “But even if the Multistate Tax Compact is a binding compact, the MTC believes it would fall into a category of compacts that allow for modification.” Taxpayers should note that general counsel provided no examples of compacts that allow for unilateral modification (absent reservation of that right in the compact itself, such as the Article VIII audit provision in the Multistate Tax Compact), and none have been cited in the briefing before the courts. The authors do not believe any exist, and none came to light in the recent U.S. Supreme Court case *Tarrant Regional Water District v. Herrmann*.²⁵

In *U.S. Steel*, the U.S. Supreme Court held that the Multistate Tax Compact does not violate the compact clause. If *Gillette* and *IBM*²⁶ uphold the Multistate Tax Compact as a binding contract, then auditing on behalf of nonparty states is contrary to the plain language of the compact.

Sicilian concluded: “But the point I want to make is even if we don’t [have the right to vary from the compact provisions], the commission is more than the compact. The commission has a job to do, and our work will continue without a compact if that’s the way it has to be.” Taxpayers may ask what might that job be: A multistate auditor for disparate tax systems? With that thought in mind, we examine the MTC’s journey from an organization focused on uniformity and a single audit under uniform rules to a vastly different organization that some argue is shifting its focus to revenue generation for the states.

The Inefficiency and Ineffectiveness of MTC Audits

In the early days of the MTC, the intended purpose of party state audits was efficiency and uniform treatment of apportionment methods. This made sense when there was a uniformity election under articles III and IV. Under current practices, however, with many states no longer following articles III and IV,²⁷ taxpayers may claim audits fail to meet the bedrock goals of uniformity and efficiency.

notification of all party States whenever there is a new enactment of the compact.” Note that the language is compact and not model law.

²⁵No. 11-889, slip. op. (June 13, 2013).

²⁶*International Business Machines Corp. v. Dep’t of Treasury*, No. 306618, Mich. Ct. App. (Nov. 26, 2012).

²⁷With 17 states listed on the MTC website as full member states, 3 have repealed Article IV containing UDITPA, 5 have modified it, and 2 have attempted to limit its use, leaving only 7 full party states.

As a result of the lack of uniformity, the commission is in reality auditing taxpayers one state at a time because the auditors need to apply a different set of rules for each state that is part of an overall audit. Some taxpayers even request this approach and appear to be granted it by the MTC. The lack of uniformity in state rules requires significant taxpayer efforts to educate the auditor on the return method in each state. Since the auditor typically comes from one state but is auditing on behalf of many, the completion of the audit is inefficient.

The MTC Audit Manual provides that “at the conclusion of the audit review, the Auditor in Charge will submit a complete hardcopy set of audit schedules to the taxpayer along with a cover letter explaining the audit adjustments. The narrative and electronic copies of the audit are not to be sent to the taxpayer in accordance with the Commission’s policy.”²⁸ Rather than obtain the audit narrative from the commission, the taxpayer must separately submit its request to each participating state, likely requiring the taxpayer to begin the protest process since it may not know the full reasoning for the assessment. Far from being efficient, this process is burdensome, results in delays in getting information, and creates confusion by requiring adherence to myriad procedural rules that vary by state.

At the conclusion of an MTC auditor’s field work, the individual state audit results and recommendations are forwarded to the appropriate state tax authority. Upon receipt of the audit report, the state is responsible for reviewing the audit and issuing whatever assessments it deems to be appropriate.²⁹ Adhering to historical commission policy emphasizing uniformity and simplification, one would expect this standardized report to serve as the basis upon which the assessment will be issued. Current practice, however, is not in line with this approach. Rather, states may use the MTC’s audit results as a starting point for further examination, even to the point of adding issues not addressed by the commission auditor. These “re-audits” add to the already burdensome task of complying with the MTC audit of what could be a dozen or more states with disparate tax rules.

In one of these cases, *Microsoft Corp., Inc. v. Office of Tax and Revenue*,³⁰ for example, after receipt of the MTC’s audit results, the District of Columbia first brought up a transfer pricing issue. In essence, this re-audit means taxpayers are doubly burdened by two audits for the same tax period.

²⁸MTC Audit Manual section 17.02

²⁹*Id.* at 17.05

³⁰No. 2010-OTR-00012, D.C. Office of Adm. Hearings (May 1, 2012).

Regarding transfer pricing audits, there is active discussion of the MTC hiring transfer pricing auditors.³¹ As transfer pricing audits are complex, highly fact intensive, and may lead to noneconomic substance and debt-equity audits, taxpayers are asking whether the commission's focus should be on improving current practices instead of expanding into this new complicated area. Recall that auditing without boundaries was a concern that existed at the time of *U.S. Steel*.

The Unduly Burdensome Nature of the Audit

A common MTC audit practice is to request a 51-state spreadsheet. The MTC Audit Manual provides that the auditor shall "obtain the taxpayer's unredacted 'all-state' apportionment work papers or source documents breaking down the . . . payroll . . . property and rents [and] each type of sale . . . for each of the years under examination."³²

Because of different rules regarding how income is apportioned, the 51-state spreadsheet provides little insight into the appropriate manner for a taxpayer's division of income in a single state. In 1968 commission members touted the advantages of simplified reporting, uniform regulations and procedures, and a uniform act that "prevent[s] overlapping and duplicative taxes." These laudable goals seem inconsistent with current practice of auditors trying to audit many diverse apportionment methods.

Further, as discussed in more detail below, any information gained through the 51-state spreadsheet that is shared outside the party states that offer an Article III choice of uniformity may be considered an unauthorized disclosure of confidential information.³³ Returns and return information are confidential and may not be disclosed by taxing authorities except as authorized by law. Some states that have tried to deny the Article III election may be in breach of the compact, and taxpayers may therefore argue that these states should not benefit from the compact's audit program.

The Inequitable Treatment of Taxpayers

Looking at the criteria for selection for audit and a recent MTC proposal for early audit closure, taxpayers are wondering if a commission audit is a one-way street — obtaining revenue for the states based on the potential of assessment rather than

collecting the correct amount of tax. Some taxpayers audited by the MTC confirmed that in the current environment states are unlikely to process refunds after a commission audit, and the early closure proposal gives the auditor a way to conclude the audit without recommending a refund to the states.

The selection criteria are explored in the Discussion Draft for Income Tax Audit Nominations.³⁴ Two criteria must exist:

- the taxpayer's consolidated federal income, line 28, must be greater than \$250 million; and
- the taxpayer must have substantial business activities in the states in which it files, such that its apportionment factors are more than de minimis.

Also, at least one of the following nine factors must exist:

- nexus likely exists in states in which it is not filing returns;
- combined reporting used improperly;
- large intercompany transactions;
- apportionment factors vary each year in states;
- nonbusiness income;
- company is large, fast growing, and possibly has insufficient compliance capabilities;
- company has significant mergers and acquisitions activity resulting in a reorganization, acquisitions, or dispositions;
- company has special-purpose entities such as REITs, insurance companies, 80-20s; or
- company is in particular service-oriented industries that have yielded significant past audit results.

The list above isn't complicated. Rather than being criteria to determine the correct amount of tax, some taxpayers express concern that the list appears to be about auditing taxpayers with the greatest potential for outstanding tax liabilities.

More concerning than the selection criteria is what happens if, during the course of an audit, the auditor determines that the taxpayer overpaid its tax liability. Since the goal of any audit is to arrive at the correct amount of tax due, it is only equitable that these overpayments be treated in the same manner as underpayments, and that refunds be granted. However, the recent proposal for early "no change" audit closure of MTC audits runs counter to this notion. The MTC Strategic Planning Steering Committee memo states as follows:

Expected outcomes from the project: We had the following goals for the project —

- Develop a process by which MTC auditors can make an early determination that an

³¹See Amy Hamilton, "MTC Considers Hiring Auditors With Transfer Pricing Experience," *State Tax Notes*, Aug. 12, 2013, p. 422; Dolores W. Gregory, "Cost of Transfer Pricing Expertise Drives States' Interest in Joint Section 482 Audits," *Weekly State Tax Report*, Aug. 23, 2013.

³²See MTC Audit Manual sections 11.02(e)(1), 11.03(e)(1), and 11.04(d)(1). (Emphasis added.)

³³See Compact Article VIII and IRC section 6103.

³⁴MTC Discussion Draft v. 1.5 2-26-13.

audit has limited or no potential for material audit adjustments, close the appropriate audit years and communicate those actions to affected states.

- Develop standards for making an early determination that an audit has limited potential for material audit adjustments.³⁵

The proposal further suggests that states should notify the taxpayer if there might be a refund. Anecdotal evidence suggests, however, that the commission and the states are not taking the responsibility for determining the correct amount of a refund due, unlike an assessment.

The proposal sets a low threshold of \$1,000 as a material amount, suggesting that anything greater is worth pursuing as revenue for an individual state. When discussing this project at the recent Audit Committee meeting, one state suggested that when the results are delivered to the taxpayer, the written transmittal needs to be clear that this would not preclude further auditing by the individual state.

The proposal states that “the auditor shall notify the taxpayer of the *nature of the potential refund*” (emphasis added). Unlike an assessment that is carefully calculated, documented, and presented to the state, only the *nature of a potential* refund needs to be communicated to a taxpayer. As a result, when the Early Audit Closure procedure is invoked, the MTC and the states may not be taking the same full responsibility for determining the correct amount of tax when a refund is possible.

Powers Granted to the MTC and Interstate Audits

There are a number of sections within the compact³⁶ that clearly define the functions and powers granted to the MTC.

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 the compact.

Article VII addresses the commission’s powers relating to proposing uniform administrative regulations and forms.

Article VIII of the compact provides that “*any party state . . . may request the commission to perform an audit on its behalf. . . . 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*” (emphasis added).

As noted in our previous article on the joint audit program, under principles of interstate compact law, the compact does not provide its administrative agency, the MTC, with any additional audit authority.³⁷ Nothing within the compact provides the commission with authority to audit or share information other than with “party states.” Thus, even if nonparty states authorize the MTC to audit on their behalf, we believe the commission does not have the authority to accept that responsibility. Despite this apparent restriction of audit power to only party states, the MTC engages in interstate audits on behalf of sovereignty, associate, and project members.

In *Gillette* and *IBM*, there is disagreement whether a subsequently enacted statute requires adoption of an alternative mandatory apportionment formula. Regarding interstate audits, there is no argument over conflicting statutory language. Compact Article VIII is clear that auditing can be done only on behalf of party states.

Auditing of nonparty states leads to the question whether the MTC should be reconstituted as some other nongovernmental form of organization (for example, a 501(c)(6) that files annual IRS Forms 990 and pays Social Security taxes on their employees). The presence of nonparty states in commission audits is likely to lead to the reprise of *U.S. Steel*.³⁸ (That is, a challenge to the MTC’s audit authority.)

Including nonparty states in the audit program also results in the unauthorized sharing of taxpayer information. Also, as the Nexus Program shares information with the Audit Committee, in which nonparty states participate, there is possibly further unauthorized information sharing and other activity.

As a result of these arguably unauthorized acts, taxpayers may have a basis for asserting that the commission’s actions have violated the prohibition on sharing confidential tax information and that the Audit Committee itself operates improperly, thus tainting all audits. Taxpayers can be expected to

³⁵MTC Strategic Planning Steering Committee Memo (July 10, 2013).

³⁶Available at <http://www.mtc.gov/About.aspx?id=76>.

³⁷See, *The Impact of Multistate Tax Compact Withdrawals on the Joint Audit Program*.

³⁸434 U.S. 452 (1978).

raise various claims if their confidential information has been improperly shared.

Some have asserted that the various grants of audit authority by the states and the Federation of Tax Administrators' Sharing Agreement make the MTC's activity permissible. Taxpayers would likely challenge those assertions under compact law. They could argue that state laws granting audit authority and the FTA agreement should be subservient to compact law under the same reasoning found in *Gillette* and should not override promises of confidentiality made in a compact.

Commission Funding and the Impact of Nonparty States

Article VIII of the compact states that the commission "shall make charges, to be paid by the State or local government or governments for which it performs the service, for any audits performed by it *in order to reimburse itself for actual costs incurred in making the audit*" (emphasis added). The Fiscal Year 2014 Budget Memo to the Members of the Executive Committee of the Commission properly notes that "audit reimbursements support the audit services provided to the states through the Joint Audit Program."³⁹

At issue, however, is whether the MTC is assessing charges directly related to the audit program that are used for more than "actual costs incurred in making the audit." The Budget Memo notes that a 20 percent fee "is added to the Audit Program fee . . . of states which are neither a Compact nor Sovereignty member. This amount is assessed on non-Compact and non-Sovereignty members to support the general operations of the Commission. . . . These fees help mitigate the need for additional increases in Membership fees." These fees from the audit program equaled approximately \$150,000 in fiscal 2012.⁴⁰

This additional 20 percent fee, which is clearly not part of the membership fee, is directly tied to the audit program and assessed only on states participating in the program, calling into question whether this charge runs afoul of the Article VIII limitation related on the audit function requiring reimbursement only for actual costs of the audit.

Further, all sovereignty members⁴¹ are nonparty states but participate in the audit program (with the possible exception of Minnesota). Note that these

states don't have the 20 percent surcharge since they are paying full member dues. If nonparty states are paying for access to taxpayer confidential information, taxpayers may ask whether the commission is accepting compensation in exchange for this confidential information.

Gillette's Impact on the Audit Program

The California Appellate Court decision in *Gillette* has resulted in a number of states withdrawing from the compact, with a few reenacting the compact without articles III and IV, the election to apportion income using either the state statutory method or UDITPA.⁴² A taxpayer victory in *Gillette* may only increase the number of states that withdraw, setting up the possible transformation of the MTC from an organization that at one time promoted uniformity, facilitated taxpayer convenience, and enhanced compliance standards into a body that arguably may be left with one function: to audit. Any state interested in membership in a compact that does not include Article III or IV would not be interested in promoting uniformity or efficiency; it would be interested only in the audit program. The joint audit program for party states makes sense when uniform apportionment is a possibility, not when the apportionment methods of the states are diverse.

Some taxpayers are concerned about the transformation of the MTC into a third-party auditor that might function under the guise of intergovernmental immunity.

Conclusion

In 1968 the MTC set upon a journey toward the establishment of equitable and just methods of resolving the tax problems of multistate businesses. Today, as the result of a lack of interstate uniformity and an inefficient, burdensome, inequitable, and arguably unauthorized audit program, the commission may have lost its reason for taking that journey. As a result, its fate may lie in the transformation from an organization that promoted uniformity and enhanced compliance standards into a body whose only function is to audit. As J.R.R. Tolkien said, "Not all those who wander are lost."⁴³ As taxpayers and states wander through the uncertainty of the interstate audit program, possibly it is time for them find ways to work together again on new solutions to the issues facing multistate taxpayers today. ☆

³⁹Memo to Members, Executive Committee (Apr. 24, 2013).

⁴⁰MTC, Fiscal Year 2014 Budget, p. 7.

⁴¹The sovereignty members are Georgia, Kentucky, Louisiana, Minnesota, New Jersey, and West Virginia. Until sometime in July 2013 South Carolina was a sovereignty member.

⁴²California, District of Columbia, Minnesota, Oregon, South Dakota, and Utah. Utah, Oregon, and the district repealed membership in the compact and then reenacted the compact provisions without articles III and IV.

⁴³A line from the poem "All That Is Gold Does Not Glitter," written by J.R.R. Tolkien for *The Lord of the Rings*.

Multistate Tax Commission 1968 Brochure on the Multistate Tax Compact

This brochure was published by the Multistate Tax Commission in 1968. It is discussed on the article on p. 597 or at Doc 2012-22865.

ERRATA

Since the publication of this brochure the following changes have been made:

Member States

Michigan as an Associate Member

Officers

C H. Mack, *Treasurer*
Chairman, State Tax Commission
State of Oregon

Statement of Purpose

To establish a Multistate Tax Commission composed of the several states for the purposes of bringing even further uniformity and compatibility to the tax laws governing multistate businesses, to give both business and the states a single place to take their tax problems, to provide an agency that can study and make recommendations on a continuing basis with respect to all taxes affecting multistate businesses, to immediately adopt and place into operation statutes and rules establishing uniformity, and to protect the fiscal and political integrity of the states from Federal confiscation.

The Multistate Tax Compact ... An Effective Answer

The Congress, business, the courts and even the states themselves have asked, "Why isn't there an effective answer to the confusion arising out of the myriad of rules and regulations that govern the taxing of businesses operating in more than one state?"

There is an effective answer. The Multistate Tax Compact . . . an agreement among the states to equitably administer the taxation of multistate business, This is a concerned effort to bring about uniformity and efficiency as well as protect the fiscal and political sovereignty of the states. The Compact

is the state's answer to Federal control of state taxing policies and programs.

The state's right to tax is axiomatic. This right has been upheld by the United States Supreme Court since the earliest days of our Republic. The power to tax is zealously guarded . . . "the taxing power is the most jealously power of government; it is also least amenable to the scientific process. Nevertheless, no one can scan the flood of cases dealing with "jurisdiction" to tax, rules for apportionment and the like, without realizing that the opportunities for taxation open to the States against common resources might find a more economic and more effective solution through negotiation than through litigation. At all events, in view of the growing burden upon time and feelings, as well as the case in money due to conflicts and the confusion arising from the administration of independent systems of State taxation, the 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." (Felix Frankfurter and James M. Landis, "The Compact Clause — A Study In Interstate Adjustments," Yale Law Journal, May 1925.)

The Multistate Tax Compact is a disciplined attack upon the entire problem of multistate business taxation. The Compact provides a definitive and effective answer for both government and business.

The Threat

There are several pieces of legislation now pending before the National Congress which would place restrictions on the administration of state taxes. These bills plus the suggestions of private individuals tend to create forces which would destroy the independence and right of decision of state tax administrators.

The principal legislation now before Congress (H.R. 2158) would, in the name of uniformity, sharply curtail the state's jurisdiction to tax with the necessary resulting loss in state revenues; would create new and extensive areas of preferential tax havens thus encouraging planned tax avoidance; and destroy the Federal system of government with the state eventually being forced into being mere agencies of the Federal Government.

These bills, before the 90th Congress, if not passed this time, will be introduced again and again until passed unless the states take positive action to stop passage.

H.R. 2158 Provides for jurisdictional limitations and regulatory provisions. This bill concerns itself with corporate income tax, sales and use tax, capital stock tax and gross receipts tax. Jurisdiction would be confined to states in which the firm has a business location. (S. 968 in the Senate)

S. 927 Allow I.C.C. common carriers to be assessed at the lowest rate in a taxing district. It could subject valuation and appraisal of every parcel of land including residence to Federal jurisdiction. Gives injunctive rights to Federal courts. (H.R. 431 and others in the House)

H.R. 2571 Extends to insured state banks the same privileges, protections and immunities available to national banks doing business in more than one state. (S. 2364 in the Senate)

H.R. 7193 Limits the imposition of state income taxes on wages and salaries of individuals to state of residence. Could mean a Federal definition of residence and domicile. (Others in the House)

H.R. 8389 Limits the jurisdiction of states to tax the income of a member of Congress representing another state, certain of his staff and specified Presidential appointees. (Others in the House)

H.R. 8798 Provides for a system of taxation of monies earned outside a state. (Others in the House)

H.R. 16054 Amends the Interstate Commerce and Federal Aviation Acts so only the state of an employee's residence can request withholding information and returns of the wages of employees employed on vehicles, trains, planes, etc., used in interstate commerce and only the state of that employee's residence may collect state income taxes.

H.R. 15932 Amends the Federal Aviation Act of 1958 to prohibit per head taxes on persons embarking on aircraft at airports within a state.

Under the terms of current proposed legislation (H.R. 2158) the Special Subcommittee on State Taxation, can within two years after enactment of the bill, and on recommendations of the Secretary of the Treasury, propose legislation which would similarly usurp the state's taxing rights in the fields of transportation, utilities, insurance companies, financial institutions, investment companies and holding companies. The Committee may also delve into the interstate aspects of state income taxes imposed on individuals and unincorporated businesses.

Other Proposals

Private persons in the field of taxation have also made proposals for taking the tax, administrative and policy making functions out of the hands of state tax administrators and placing them under the jurisdiction of the Federal Government.

At the Tax Executive Institute's Symposium in December of 1967 the following proposals were put forth:

1. A plan which would allow Congress to fix the measure of tax, the apportionment and allocation schedules used by the states and the rate of the tax, federally prescribed and apportionment and allocation methods with standards for their use set by a Federal administrative agency and all regulations, Federal or state, subject to Federal interpretation.

2. Use of the Commerce Clause to give the Federal Government unlimited taxing powers in the area of multistate business and unlimited power to dictate state tax administration. There would be no freedom of action by the states except as allowed by the Congress.

Many of these features can be accomplished by the Multiscate Tax Commission and in a manner equitable to all.

What's at Stake? The 'Indispensable' Power To Tax

"Although many of the powers formerly exercised by the states are transferred to the Government of the Union, yet the state governments remain and constitute a most important part of our system. The power of taxation is indispensable to their existence . . ." (Chief Justice Marshall in *Gibbons v. Ogden*, 1824)

". . . the taxing power of a state is one of its attributes of sovereignty. . . It exists independently of the Constitution of the United States, and underrived from that instrument. . . And in thus acknowledging the extent of the power to tax belonging to the states, we have declared that it is indispensable to their continued existence." (Justice Strong in *Union Pacific R.R. v. Peniston*, 1873)

"The formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods . . . to permit such formal 'contractual shifts' to make a constitutional difference *would open the gates to the stampede of tax avoidance* . . ." (Justice Clark in *Scripto v. Carson*, 1960)

Are the states, by cooperative action, to adjust their taxing systems to the modern needs of our national economy and thereby keep control of this "indispensable" power? Or will the Federal Government attempt it for them, and thereby take control away from them and place their taxing power at the sufferance of the Federal Government? This is what's at stake.

The Governors Speak on the Issues

The states should be free to design and make rules for the equitable administration of taxes. This Multistate Tax Compact is a step toward the realization of this goal . . . Stan Hathaway, Wyoming.

. . . the most expeditious is the methodology of the Multistate Tax Compact which provides the machinery for voluntary and collective interstate solutions . . . Otto Kerner, Illinois.

The Multistate Compact is an effort by the states to insure that taxes are equitable to multistate taxpayers, and also equitable to local taxpayers and to local and state governments . . . John A. Love, Colorado.

Responsible government requires us to maintain close contacts with those discussing state taxation of multistate business corporations and firms whenever such deliberations appear likely to be productive and beneficial to taxpayer and state alike . . . Hulett C. Smith, West Virginia.

The solutions of the legitimate problems of interstate taxation lie in uniformity rather than in the preferential exclusion of multistate businesses from state taxation . . . Ronald Reagan, California.

The Compact is drafted in such a manner as to provide equitable treatment for the multistate taxpayer and maintain the necessary autonomy to allow state and local governments to operate effectively . . . Roger D. Branigin, Indiana.

It is just as unthinkable to consider nationalizing state and local taxes as nationalizing industry . . . Nelson Rockefeller, New York.

The states must be willing to assume the responsibilities of self-government, which includes providing adequate financial resources. Only by such action can they keep their fiscal and political independence. The Compact provides us with the tool to take such action. It is a test of our whole Federal system . . . Daniel J. Evans, Washington.

. . . be it further resolved by the National Governor's Conference that it pledges its best efforts to reach an agreement among the states on an interstate (tax) compact . . . National Conference of Governors, December 1966.

Multistate Compacts Do Work

With respect to handling significant problems which are beyond the unaided capabilities of the regularly constituted agencies of individual state governments, the accepted instrument is an interstate compact or agreement.

Compact agreements *do* work. For example . . .

The Interstate Compact for the supervision of Parolees and Probationers. Operates in all 50 states, the Commonwealth of Puerto Rico and the Virgin Islands.

The Interstate Civil Defense and Disaster Compact. Operates in all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands and Guam.

The Vehicle Equipment Safety Compact. Enacted by 44 states and the District of Columbia.

The Interstate Compact on Juveniles. In force in 42 states.

The Compact for Education. Operates in 36 states, the Commonwealth of Puerto Rico, the Virgin Islands and American Samoa.

The Interstate Compact to Conserve Oil and Gas. Operates in 30 states.

Presently over 144 multistate compacts are in operation among the states. Some compacts administer, others regulate and still others act in an advisory capacity to their members.

The Committee for Economic Development has recommended "interstate cooperation in solving mutual problems be exploited actively through interstate compacts. Every state should explore the opportunities for cooperation through the use of interstate compacts." The Committee also recommends "all 50 states greatly intensify their efforts to adopt uniform state tax laws."

History

The history of the Compact is the history of the states' struggle to save its fiscal and political independence from the encroachments of the Federal Government as embodied in several pieces of legislation before the Congress. This legislation purports to bring about uniformity but in reality usurps the power of the states in the fields of taxation and tax administration in regard to multistate businesses.

The chronology of the Compact is as follows:

January 1966 Plan for Compact envisioned at meeting of the National Association of Tax Administrators.

February to December 1966 Committee of attorneys general and tax administrators under the auspices of the Council of State Governments, drafted the Compact.

November 1966 Final drafting session held.

December 1966 Compact draft amended and completed.

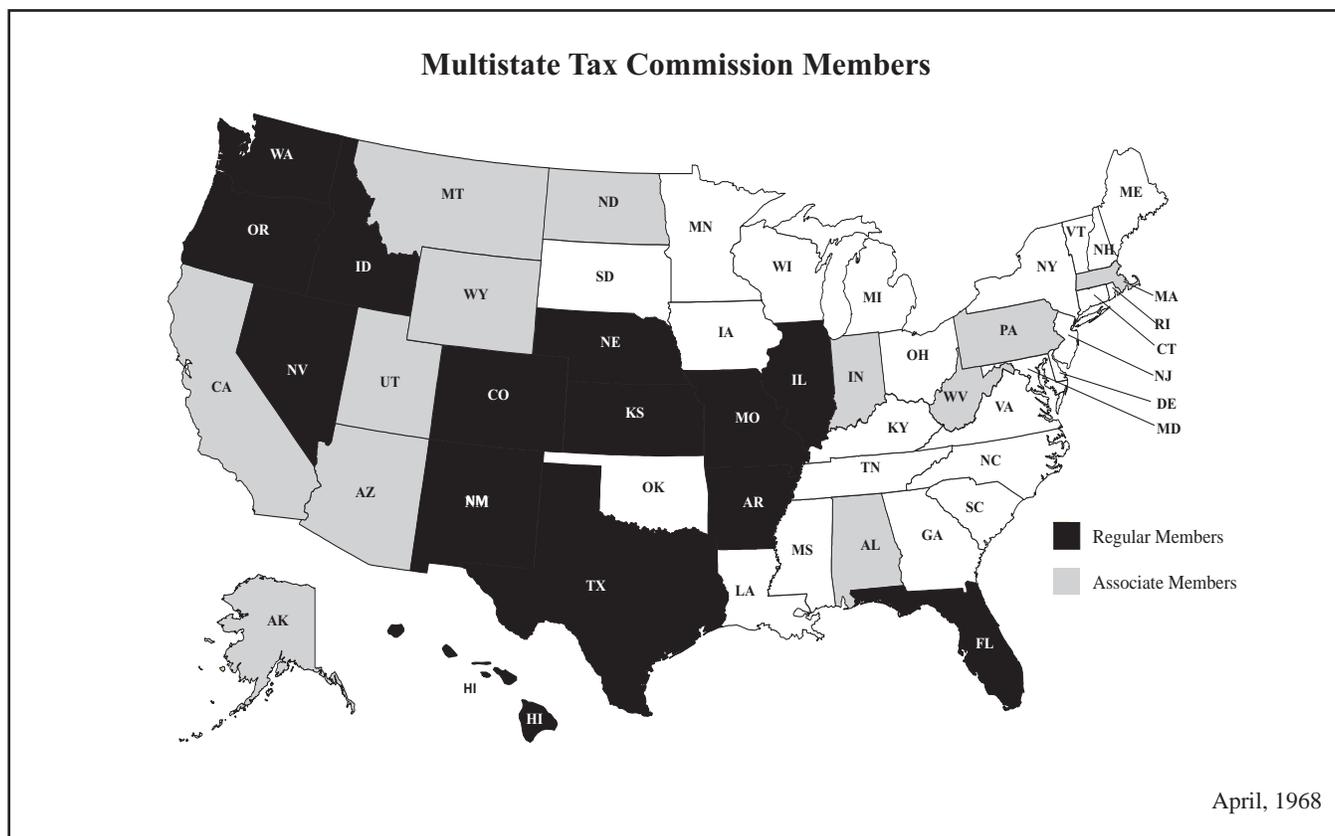
June 1967 Organizational meeting, San Francisco. Attended by 11 states whose Legislatures had approved the Compact.

August 4, 1967 Compact becomes legally effective.

October 1967 First legally authorized meeting held in Washington, D.C.

January 1968 Second regular meeting held in Kansas City. Committee assignments and other plans placed into action.

April 1968 Twenty-sixth state joins Compact Commission.



Member States

Twenty-six states have joined the Commission since it was organized in June, 1967. Fourteen states are regular members; twelve are associate members.

Regular members are states whose Legislatures have enacted the Compact They include:

- | | |
|----------|------------|
| Arkansas | Missouri |
| Colorado | Nebraska |
| Florida | Nevada |
| Hawaii | New Mexico |
| Idaho | Oregon |
| Illinois | Texas |
| Kansas | Washington |

There are two types of associate members. States who have joined the Commission by proclamation of their respective governors . . .

- | | |
|---------------|---------------|
| Alaska | Montana |
| Arizona | North Dakota |
| California | Pennsylvania |
| Indiana | Utah |
| Massachusetts | West Virginia |

. . . and states whose Legislatures have passed the Compact but, made adoption dependent on subsequent conditions.

Alabama

Wyoming

Advantages to the States

- Preservation of tax administration
- Exchange of audit information
- Single audits
- Protection of fiscal and political sovereignty
- Voluntary compliance of taxpayers
- Lower compliance costs
- Continuous research into multistate tax problems
- Continuous legal, technical and tax consulting through the use of outside advisors and exchanges of information between the states
- One agency for businesses to present their views, problems and suggestions
- Joint corrective action of multistate tax problems
- Advisory administrative rules
- Advisory regulations for uniform statutes
- Allow for business expansion within any given state

Advantages to Business

One tax agency . . .

A single place for business to bring its tax problems arising out of multistate operations. The Commission gives multistate business the

opportunity to deal with one agency instead of many — in some cases as many as 50.

Elimination, of charges for out-of-state audits . . .

The Commission can conduct one audit of a taxpayer doing business in more than one state or subdivision. This information is available to the states in which he does business or the United States for tax purposes only. The taxpayer is not charged for the cost of an audit. The states requesting the audit are charged for the actual costs incurred.

Provide credits for sales taxes previously paid . . .

To prevent duplicative taxation of articles acquired outside the state, an offset is specifically allowed against the use tax for sales or use taxes paid on the same property to any other state or subdivision.

Choice of Uniform Division of Income Act or state income tax allocation system . . .

Businesses required to pay income tax in more than one state or subdivision can choose between the allocation methods of the Uniform Division of Income Act or those of the state or subdivision.

Prevents Overlapping and duplicate taxes . . .

The Uniform Division of Income Act and the sales and use tax credits are examples of methods used to prevent overlapping and duplicate taxes.

Solve interjurisdictional problems . . .

Business can request an arbitration board be convened to settle disputes over apportionment and allocation of taxes. The business may appeal to the Board from the final administrative determination of a state. This article goes into effect when the Commission, by the adoption of a regulation, determines there is a need for it. The ruling of the Board is binding on all Compact states in which the taxpayer does business.

One audit for all states . . .

Allows the multistate taxpayer the advantage of having just one audit which can be used by all party states for tax purposes only.

Simplified reporting . . .

Development of methods to simplify the reporting of taxes when more than one state or subdivision is involved will benefit business. The provision allowing businesses with sales of \$100,000 or less to pay a flat rate on the basis of percentage of volume is an example of this simplification.

Standard forms . . .

One of the advantages to business will be the use of standard forms for reporting among the

states. This standardization is another step Towards uniformity and simplification.

Uniform regulations . . .

Uniformity is aided by the making of advisory administrative regulations applicable to any uniform provisions of statutory law.

Uniform procedures . . .

Procedures for reporting, allocating and collecting of taxes of multistate businesses operating in more than one state or subdivision would be standardized.

**The Multistate Tax Compact
... A Brief Summary**

The Multistate Tax Compact *is* composed of two parts; the Compact itself, consisting of 12 articles, and the accompanying “Enabling” legislation.

ARTICLE I

Statements of Purpose

ARTICLE II

Definitions

ARTICLE III

Allows a taxpayer whose net income is taxable in more than one state to elect to apportion and allocate his income on the basis of the apportionment policies of the state or subdivisions, or alternatively on the basis of the Uniform Act contained in Article IV.

Provides a simple way for companies with sales of \$100,000 or less to pay flat rate on the basis of the percentage of volume and without having to file a complicated return.

ARTICLE IV

The Uniform Division of Income for Tax Purposes Act.

ARTICLE V

Provides for a claim for credit of sales or use taxes on property subjected to the same tax in another state or subdivision.

Recognizes resale or exemption certificates accepted and received by a vendor from a purchaser which relieves the vendor of liability for a sales or use tax on the transaction.

ARTICLE VI

The organization and management of the Multistate Tax Commission. The Commission is made up of a representative from each member state who is the head of that state’s taxing agency.

Provides for annual reports to the Governor and Legislature of member states. Provides for an Executive Director to handle day-to-day business of the Commission. Provides for the

study of state and local tax systems and particular types of taxes. Provides for the development and recommendation of proposals which would increase uniformity and simplify and improve tax laws and administration.

ARTICLE VII

Provides for the adoption of regulations which will give a uniform interpretation of uniform or similar tax laws. These regulations will be binding on states adopting them.

ARTICLE VIII

Multistate audits. Permits one audit of a multistate taxpayer by the Commission and made available to party states for tax purposes only. Each state must specifically adopt this article.

ARTICLE IX

Provides for an "Arbitration" procedure which will give the taxpayer a forum within which to have uniform determination as to apportionment, which will be binding on all Compact states in which the taxpayer does business.

This article goes into effect when the Commission, by the adoption of a regulation, determines there is a need for it.

ARTICLE X

Explains when Compact enters into force and how members may withdraw from the Compact.

ARTICLE XI

Effect of Compact on other laws.

ARTICLE XII

Construction and Severability.

Cooperations with Business

To better understand the tax problems of business in regard to their multistate operations, the Commission has maintained contact with various businesses and business organizations since its inception. This liaison with business has been an asset to the Commission and underlines the philosophy of finding equitable and just methods of resolving the tax problems of multistate businesses.

Business organizations who have sent observers to Commission meetings are:

Advisory Commission on Intergovernmental Relations

American Arbitration Association

American Bar Association

American Institute of Certified Public Accountants

Bureau of National Affairs

Chamber of Commerce of the United States

Columbia Broadcasting System

Commerce Clearing House, Inc.

Council of State Governments

Montgomery Ward

Monsanto Company

National Association of Manufacturers

National Retail Merchants Association

Prentice-Hall, Incorporated

Tax Executives Institute

Various Local Chambers of Commerce

Various State Bar Associations

Weyerhaeuser Company

Advisors and Consultants

A distinguished group of men, prominent in business and academic circles, serve as advisors and consultants to the Multistate Tax Commission.

- Charles B. Bayly, Jr. Tax Counsel, Columbia Broadcasting System
- Robert Coulson Executive Vice President, American Arbitration Association
- John Due Professor of Economics, University of Illinois
- Lee Hill General Tax Counsel Humble Oil & Refining Company
- Max Kaminoff Attorney, Bogle, Gates, Dobrin, Wakefield & Long, Seattle
- Art McCourt Assistant to the Controller, Weyerhaeuser Company, Representing the Tax Executives Institute
- William Pierce Professor, University of Michigan Law School President, National Conference of Commissioners on Uniform State Laws
- Donald H. Webster Professor of Political Science, University of Washington

Interest Among Non-Member States

Enthusiastic acceptance of the Compact method and the Multistate Tax Commission as an answer to the problems of uniformity of state tax laws and as a buffer against Federal encroachment on the taxing powers of the states has been expressed by an interest in the Compact on the part of a large number of states. Along with the 26 states who are now members of the Commission, 16 others have sent observers to Commission meetings.

A Look to the Future

The Compact and the resulting Multistate Tax Commission are not just instruments of today. They are the vehicles on which ride the tax problems of tomorrow. The Commission offers the most exciting promise for progress in the field of multistate taxation.

The research program of the Commission will be able to identify problems of the future and provide for its members alternatives for problem solution, either on an individual basis or through cooperative action. The Commission will be a vehicle through which the states can exchange information and develop new cooperative programs not yet visualized.

The real genius of the Compact is its look to the future. It has a service for all states and business alike.

Multistate Tax Commission

OFFICERS

George Kinnear, Chairman Director, Department of Revenue State of Washington

Thomas A. David, Vice Chairman Director, Department of Revenue State of Missouri

F. H. W. Hoefke, Treasurer Chairman, State Tax Commission State of Oregon

EXECUTIVE COMMITTEE

James T. McDonald Director, Department of Revenue State of Kansas

F. A. Vigil Commissioner of Revenue State of New Mexico

Kenneth Kimbro Chief Clerk and Tax Administrator State of Texas

J. Ed Straughn Director, State Revenue Commission State of Florida

S. Ed Tveden Acting Director and Secretary Multistate Tax Commission c/o Department of Revenue Washington State Olympia, Washington 98501 Telephone: (206) 753-5526 ☆