No. 15-1442

IN THE
# Supreme Court of the United States

THE GILLETTE COMPANY, ET AL.,
*Petitioners*,
v.

CALIFORNIA FRANCHISE TAX BOARD, ET AL.,
*Respondents*.

**On Petition for a Writ of Certiorari to the Supreme Court of California**

# BRIEF OF TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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## BRIEF OF TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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## INTEREST OF *AMICUS CURIAE*[1]

Tax Foundation submits this brief as *amicus*

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *Amicus* represents that it authored this brief in its entirety and that none of the parties or their counsel, nor any other person or entity other than *Amicus* or its counsel, made a monetary contribution intended to fund the preparation or submission of this brief. Pursuant to Rule 37.2(a), counsel for *Amicus* represents that all parties were provided notice of *Amicus*'s intention to file this brief at least 10 days before its due date. Letters from the parties consenting to the filing of the brief have been filed with the Clerk of the Court.

*curiae* in support of Respondent in the above-captioned matter.

The Tax Foundation is a non-partisan, non-profit research organization founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., we seek to make information about government finance more accessible to the general public. Our analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability. The Tax Foundation's Center for Legal Reform furthers these goals by educating the legal community about economics and principled tax policy.

This Court's decision will provide guidance on the nature of interstate compacts and to what extent their provisions are binding on the states who ratify them. Compacts in general and the Multistate Tax Compact in particular play a vital role in defining the scope of state tax authority. Because *Amicus* has testified and written extensively on the issues involved in this case, because this Court's decision may be looked to as authority by the many state courts considering this issue, and because any decision will significantly impact taxpayers and state tax administration, *Amicus* has an institutional interest in this Court's ruling.

## SUMMARY OF ARGUMENT

This case is seemingly about business tax refund claims in one state, with similar cases from several other states likely to reach this Court in the near future. However, what this case is really about is whether a state seeking to reclaim its sovereignty from a compact (1) must follow the procedures of the compact and withdraw from it or seek amendments to it, or (2) can simply enact a contrary law and thereby

unilaterally alter the terms of the compact. Also at issue is the question of what separates an advisory institution from a binding compact.

The Multistate Tax Compact was created and enacted by the signatory states in response to the threat of federal encroachment on states' taxation powers. Through its reciprocal agreement that all states offer the UDITPA formula as a default apportionment formula, the stated goal of creating a baseline level of uniformity for multistate tax apportionment was achieved. Now, with little threat of federal encroachment, California and other states claim that the Compact was never binding on them, and are denying taxpayers the ability to use a "safety valve" provision in the Compact. The Compact's governing entity, the Multistate Tax Commission, today supports this interpretation for institutional reasons but a large body of statements and reports by the Commission at the time, as well as a full understanding of the purposes of the Multistate Tax Compact, demonstrate that all parties understood the Compact to be binding.

Allowing California to unilaterally amend a compact it has adopted, rather than seeking to amend it or withdrawing from it, will undermine the entire concept of interstate compacts as binding agreements between states and strip the states of an incredibly important tool used to foster interstate cooperation. This Court has in the past recognized the importance of such agreements and the unique role they play in fostering cooperation between states, and should act to protect them from destruction.

## ARGUMENT

### I. THE MULTISTATE TAX COMPACT WAS CREATED BY STATES TO GUARANTEE UNIFORM STATE APPORTIONMENT BUT IN A WAY MORE FLEXIBLE FOR STATES THAN THREATENED FEDERAL LEGISLATION WOULD HAVE ACHIEVED.

Multistate corporate taxation necessitates the use of an apportionment rule to determine how much of a multistate taxpayer's income can be subject to tax in each state. If apportionment rules between states are the same, 100 percent of a taxpayer's income will be attributed to somewhere, avoiding double taxation. When apportionment rules are not uniform, taxpayers face complexity, burdensome compliance costs, and duplicative taxation.

States have an institutional incentive to resist apportionment uniformity, because weighting the sales factor a little bit more than every other state gives you a competitive advantage: it makes tax burdens a little lower for your homegrown businesses and a little higher for out-of-state businesses who sell into your state. The innate tendency of states, individually and collectively, to shift tax burdens to out-of-state individuals and businesses despite the resultant harm to the national economy, is well-documented in this Court's cases. *See, e.g.*, *Maryland v. Wynne*, -- U.S. ---, 135 S.Ct. 1787, 1792 (U.S. May 18, 2015) (invalidating Maryland's income tax credit that had the effect of taxing out-of-state income twice); *Camps/Newfound/Owatanna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (invalidating Maine's denial of the general charitable deduction to organizations that primarily serve non-Maine

residents); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994) (invalidating a Massachusetts general tax on dairy producers where the revenue was then distributed to domestic dairy producers); *New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (invalidating an Ohio tax credit to all ethanol producers but disallowed for non-Ohio producers); *Am. Trucking Ass'n v. Scheiner*, 483 U.S. 266 (1987) (invalidating a Pennsylvania scheme imposing fees on all trucks while reducing other taxes for trucks in-state only); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) (invalidating a Hawaii tax imposed on a category of products but exempting activity in-state); *Westinghouse Elec. Co. v. Tully*, 466 U.S. 388 (1984) (invalidating a New York scheme exempting activity in-state while simultaneously imposed a tax on identical activity out-of-state); *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318 (1977) (invalidating a New York tax imposed solely on activity out-of-state while leaving identical activity in-state untaxed).

The people of the United States adopted the U.S. Constitution in large part because their existing national government had no power to stop states from imposing tax and trade barriers between each other, to the detriment of the national economy. *See, e.g.*, *EEOC v. Wyoming*, 460 U.S. 226, 244-45 (1983) (Stevens, J., concurring) ("[The commerce] clause was the Framers' response to the central problem that gave rise to the Constitution itself."); *Gibbons v. Ogden*, 22 U.S. 1, 224 (1824) (opinion of Johnson, J.) (stating that pre-constitutional state taxation of interstate commerce was "destructive to the harmony of the States, and fatal to their commercial interests abroad. This was the immediate cause that led to the

forming of a convention."); JAMES MADISON, THE FEDERALIST NO. 42 (1788) ("[T]he mild voice of reason, pleading the cause of an enlarged and permanent interest, is but too often drowned before public bodies as well as individuals, by the clamours of impatient avidity for immediate and immoderate gain.").

The first attempt to work out uniform state apportionment of multistate taxpayers occurred in July 1957 when the National Conference of Commissioners for Uniform State Laws, a respected drafter of model state laws, drafted a model apportionment law called the Uniform Division of Income for Tax Purposes Act (UDITPA). This model law calculated apportionment as the average of: (1) the cost of the taxpayer's real property in the taxing state, divided by the total cost of its property; (2) the compensation of the taxpayer pays employees in the state, divided by its total payroll; and (3) the taxpayer's gross sales in the state, divided by its total sales. That figure would then multiplied by the taxpayer's total income to determine its tax base within the state. Between 1957 and 1964, however, only Alaska, Arkansas, and Kansas adopted this "three-factor formula" from UDITPA.

Then suddenly, between 1964 and 1967, nearly all states adopted UDITPA, and the states proposed and ratified the Multistate Tax Compact. What suddenly motivated the states was not a sudden inspiration to promote good tax policy and national uniformity, but the threat of congressional action to permanently take away their ability to manipulate apportionment formulas. In 1965, Congress produced the Willis Committee report after extensive hearings into the problems of multistate taxation. The Willis Committee concluded that a uniform apportionment

rule was desirable and proposed federal legislation establishing a two-factor formula: using property and payroll but not sales, reasoning that taxing businesses with property and payroll in the state was a good proxy for the use of state services. The Willis Committee specifically criticized non-uniformity in apportionment formulas and the frequency of states to change them. Federal legislation to implement a standard two-factor apportionment formula was duly introduced in the 1965 Congress.

This is how the Multistate Tax Compact was born: unable to "beat" a uniform apportionment rule, the states decided to "join" it, by setting up a framework for uniform apportionment using their preferred three-factor formula. *See, e.g.*, Billy Hamilton, "What Did the MTC Think and When Did They Think It?," 66 STATE TAX NOTES 751, 752 (2012) ("[Recent authors have] argued that the compact's original intent -- and one of the principal reasons for the MTC's creation -- was to create uniformity in multistate business taxation. That's true -- but only up to a point. The agreement, they said, was a grand bargain to prevent Congress from imposing further limitations on the states' ability to tax multistate businesses and the imposition of a uniform apportionment formula."); *Moorman Mfg. Co. v. Bair*, Amicus Curiae Brief of the Multistate Tax Commission and Attorney General of Oregon (Jan 3, 1978) ("[The Court] should conclude that the generally accepted, equally weighted three-factor formula of property, payroll, and sales (UDITPA) constitutes the constitutional standard for state income tax apportionment purposes . . . ."); Multistate Tax Commission, Second Annual Report (1969) at 19-20, http://www.mtc.gov/uploadedFiles/Multistate_Tax_C

ommission/Resources/Archives/Annual_Reports/FY68-69.pdf (quoting favorably from a National Governors' Conference report advocating that uniformity be achieved by Congress requiring the three-factor apportionment formula for states that have not adopted the Multistate Tax Compact by 1971); Multistate Tax Commission, First Annual Report (1968) at 10, http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Resources/Archives/Annual_Reports/FY67-68.pdf ("So no one can doubt that the Compact states have already moved and will continue to work for simplification, uniformity, and equity in the treatment of multistate taxpayers. But it cannot be said that the threat of coercive, restrictive federal legislation is gone."); Multistate Tax Commission, Brochure on the Multistate Tax Compact (1968) ("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 states' answer to federal control of state taxing policies and programs."). Satisfied that its recommendation for uniformity had been achieved through the Compact, Congress turned its attention to other areas and dropped the Willis Committee's recommendations.

One key difference between the Compact as adopted and the stillborn federal legislative proposals was that the Compact did not require states to adhere forevermore to the three-factor formula, but instead included a "safety valve" that permits taxpayers to invoke the three-factor formula if a ratifying state changes its apportionment laws. *See* Multistate Tax

Compact, art. III ("Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party State . . . may elect to apportion and allocate his income in the manner provided by the laws of such State . . . without reference to this compact, or may elect to apportion and allocate in accordance with Article IV [the three-factor formula]."). Everyone at the time, including this Court, understood that taxpayers had an apportionment option between state law and the Compact's three-factor formula, if they differed, and that providing that choice was binding on states who ratified to the Compact. *See, e.g.*, *U.S. Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452, 457 n.6 (1978) ("The Uniform Division of Income for Tax Purposes Act, contained in Art. IV, allows multistate taxpayers to apportion and allocate their income under formulae and rules set forth in the Compact or by any other method available under state law."); MTC Chairman Greg Kinnear, Remarks to the National Association of Tax Administrators (Jun. 15, 1967), http://goo.gl/RXw0FM ("With respect to consent, the Chairman stated his view that the Compact was a legally binding instrument without congressional consent."); Council on State Governments, *The Multistate Tax Compact: Summary and Analysis* (1967) ("Each party State could retain its existing division of income provisions but it would be required to make the Uniform Act [UDITPA three-factor formula] available to any taxpayer wishing to use it. Consequently, any taxpayer could obtain the benefits of multi-jurisdictional uniformity whenever he might want it."). This "safety valve" allowed states to retain their independent taxing power while also providing a minimal baseline of uniformity for taxpayers.

## II. WITH LITTLE THREAT OF FEDERAL LEGISLATION, STATES NOW DENY THE BINDING NATURE OF THE MULTISTATE TAX COMPACT AND THE EXISTENCE OF THE SAFETY VALVE ELECTION.

As soon as the threat of federal action receded, states resumed tinkering with their apportionment formulas for parochial advantage. In 1978, this Court upheld Iowa's sales-only apportionment formula as constitutionally permissible. *See Moorman Mfg. Co. v. Bair*, 439 U.S. 885 (1978). Other states mimicked what Iowa had done. California drafted Amendment § 25128 as a way to make that the exclusive formula used by the state. The goal of this double-weighted sales formula was to encourage economic development by reducing the tax burden from locating jobs and investment in California and increasing tax on out-of-state corporations exploiting California's market. Today, only 9 states (Alaska, Delaware, Hawaii, Kansas, Louisiana, Missouri, Montana, North Dakota, and Oklahoma) adhere to the UDITPA (or, perhaps more accurately now, DITPA) three-factor formula. Every other state with a corporate income tax either more heavily weights or exclusively weights the sales factor. Consequently, it is not unusual for multistate corporations to see their share of income attributed to each state add up to well over 100 percent.

Why the Compact did not restrain the states as they rushed to change their apportionment formulas is a source of dispute in this case. Respondents argued in the courts below that the Compact did not restrain the states because the Compact is not binding and never has been, and instead is a model law which states are free to adopt all of, some of, or none of.

Petitioners did not directly address why things went so long without objection, instead arguing that the Compact's language and contemporaneous documents make clear that the Multistate Tax Commission said it was binding and contemporaneous documents and statements all said it was binding, and that it had to be binding to stave off federal legislation in the 1960s and early 1970s. This Court may be interested in the Tax Foundation's best guesses as to why no one invoked the Compact election these many years: (1) the concentrated benefits/diffused costs problem: in-state companies generally like greater weighting of the sales factor in their home state, and they lobbied harder for that benefit than the wide variety of out-of-state companies who might be inclined to fight it; (2) multistate taxpayers often try not to antagonize state tax administrators and may have just gone along with state law rather than invoking the Compact so as to avoid other negative consequences; and (3) the trend toward single sales factor, and accompanying throwback and throwout rules, accelerated only gradually, and maybe didn't become a consequential issue worth invoking (or rediscovering) the Compact election until recently. The California provision at issue here was not adopted until 1993, for example.

Regardless of why, as soon as companies starting invoking the Compact election in 2003, states began denying the existence of the "safety valve" as something companies can invoke in states that have ratified the Compact. The MTC, eager to stanch a sudden exodus of member states seeking to turn off the safety valve by leaving the MTC, began filing amicus briefs claiming that it is merely an advisory entity with no authority to require states to do anything. The MTC notes that states can choose to

adopt or not adopt any rules and regulations proposed by the Commission, although this argument blurs the distinction between binding provisions of the Compact itself and subsequent regulations developed by the Commission that the Compact states are not binding on states unless affirmatively enacted.

More than merely providing advice, the MTC is a coercive sovereign entity consisting of state tax administrators, who hold hearings on and adopt policies and regulatory rules, submit briefs purporting to represent the perspective of state governments, lobby state legislators to defend its authority from encroachment and secure funding for enforcement and audit activities, and run joint interstate audit programs that wield subpoena power that collect and use confidential taxpayer information. The MTC is not some mere trade association or negotiating forum. It is an entity to which states transfer some of their sovereignty so that it may act as a representative of the states as a whole, or more accurately as the voice of state tax administrators nationwide.

The Compact itself for the most part is inconvenient for the Commission's recent recasting of itself as an advisory entity, given that it uses the word "Compact" and has a lot of language that sounds like a binding agreement that states must adhere to unless they withdraw. For example, the MTC changed its website version of the original 1967 compact to delete language stating that MTC audit programs are only available to "party States," inconvenient language if you're denying that it's a binding compact. *See* Michael D. Herbert, Bryan Mayster, Sarah Massimino, & Justin Ploeger, *The Multistate Tax Commission—Beyond the Limits of Advice?*, 76 STATE TAX NOTES 1041, 1044 n.20 (2015). (The term "party

state" is used 49 times in the Compact.) The Compact only took effect on ratification by a certain minimum of members, and there are lower levels of membership for states that have not fully adopted the Compact. States only get voting rights on the Commission if they adopt the Compact, which is strange if the Commission's purpose is just discussing issues of importance to all states.

The court below erred in concluding that the MTC is an advisory body and that the states surrendered no sovereignty by ratifying the Compact and joining the Commission. While it is in California's interest, and the MTC's current interest, to claim that California and other states have the power to unilaterally change the terms of the deal struck in 1967, such a reading ignores why the Compact was created, why states joined it, the statements by the Commission leaders in its first few crucial years fighting federal encroachment, and the sovereign-like activities of the MTC.

## III. ALLOWING CALIFORNIA TO UNILATERALLY CHANGE THE TERMS OF THEIR COMPACT POSES A SERIOUS THREAT TO OTHER IMPORTANT INTERSTATE COMPACTS.

Interstate compacts have historically played a crucial role in furthering cooperation between states while still allowing them to retain their sovereignty. *See, e.g.*, *Hinderlider v. La Plata River & Cherry Creek Ditch Co.,* 304 U.S. 92, 104 (1938) (discussing history of interstate compacts dating back to the Colonies); *West Virginia ex rel. Dyer v. Sims*, 341 U.S. 22, 24 (1951); Felix Frankfurter & James Landis, *The Compact Clause of the Constitution – A Study in*

*Interstate Adjustment*, 34 YALE L.J. 685 (1925) (discussing history and expansive uses of interstate compacts). Compacts play a crucial role in resolving disputes in a wide array of areas, including state boundaries, social service delivery, emergency management, law enforcement, corrections and post-conviction supervision, education, professional licensing, and insurance. This Court has described their role as crucial to addressing "interests and problems that do not coincide nicely with either the national boundaries or with State lines." *Hess v. Port Authority Trans-Hudson Corp.,* 513 U.S. 30, 40 (1994). Compacts represent cooperation by different states in addressing problems that are regional in nature. Because compacts do not fit nicely into one single body of law, courts have drawn from both contract law and reciprocal statutory law in order to address them. *See* BROUN, THE EVOLVING USE AND THE CHANGING ROLE OF INTERSTATE COMPACTS (2006) § 1.2 at 17-24; *Texas v. New Mexico,* 482 U.S. 124, 128 (1987); *Doe v. Ward,* 124 F. Supp. 2d 900, 914-15 (W.D. Pa. 2000).

Allowing California to unilaterally amend the terms of the Compact would undo almost fifty years of settled compact law and would open the door to unilateral amendment on nearly all current compacts which haven't been approved by Congress. *See* BROUN, THE EVOLVING USE AND THE CHANGING ROLE OF INTERSTATE COMPACTS (2006) § 6.4 at 156 ("Once [a compact has been] adopted, the only means available to change the substance of the compact (and obligations it imposes on a member state) is through withdrawal and renegotiation of its terms, or through an amendment adopted by all member states in essentially the same form.").

One of the more notable compacts that would be put at risk is the ICPC which governs the interstate placement of children in foster care and adoption. *See* Cal. Fam. Code § 7900 *et seq.*; *In re C.B.*, 188 Cal. App. 4th 1024, 1030 (2010). This compact currently has 52 member jurisdictions and is similar to the compact at issue in this case. The administrative body of the ICPC, the AAICPC, performs similar functions as currently claimed by the Multistate Tax Commission. The Secretariat of the AAICPC provides ongoing administrative, legal and technical assistance to member states. *See* BROUN, THE EVOLVING USE AND THE CHANGING ROLE OF INTERSTATE COMPACTS § 9.2.2 at 241.

Another compact at risk of being rendered ineffective is the Interstate Compact on Juveniles which governs the interstate supervision of juveniles on probation and parole. *See* Cal. Wel. & Inst. Code §§ 1400 *et seq.*; *In re Crockett*, 159 Cal. App. 4th 751 (2008). Similar to the Multistate Tax Compact, there was no official delegation of rulemaking authority to a central body. Although the administrative agency created by that compact, the AJCA, has assumed such a role and has promulgated rules, the lack of official authority to do has rendered these rules more akin to voluntary conventions than rules binding on the states. *See* BROUN, THE EVOLVING USE AND THE CHANGING ROLE OF INTERSTATE COMPACTS § 9.1.4 at 214-215. Again, if following holding of the Court below, the lack of official authority to promulgate rules for member states of the compact strips the AJCA of its title as a regulatory agency and creates doubt as to the binding nature of the compact itself.

A third notable compact that will be affected by the holding in this case is the Driver's License

Compact which requires party states to report and recognize out-of-state driving offenses to ensure roadway safety. *See* Cal. Veh. Code §§ 15000 *et seq.*; *McDonald v. DMV*, 77 Cal. App. 4th 677, 682 (2000). This compact is currently in effect in 45 states and like the Multistate Tax Compact, the Driver's License Compact is entered through the adoption of uniform legislation by member states. The administrative authority created by the compact, a board, has undefined legal parameters and has mainly issued guidance to the states concerning their state to state procedure. *See* BROUN, THE EVOLVING USE AND THE CHANGING ROLE OF INTERSTATE COMPACTS § 9.1.6 at 226. This is nearly identical to the currently stated role of the Multistate Tax Commission.

While these are the most notable compacts at risk, this is by no means an exhaustive list.

Compacts work because all parties involved are bound to the terms they agree upon. Without the assurance that compacts will be treated as binding contractual agreements, compacts would essentially be stripped away from the states as a tool to solve regional problems. This Court has in the past recognized the importance of such agreements and the unique role they play in fostering cooperation between states, and needs to act to protect them from destruction.

## CONCLUSION

For the foregoing reasons, *Amicus* respectfully request that this Court grant the petition for certiorari.

Respectfully submitted,

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