A Victory for Interstate Compacts

Background
The Multistate Tax Compact, which was drafted in 1967 and has been adopted by 19 states, promotes interstate uniformity among state tax systems. The terms of the compact require member states to equally consider a company’s sales, property and payroll taxes when determining what percentage of the company’s income is taxable. The compact also allows companies to apportion their taxable income under state laws if those are more generous.

California, which joined the agreement through legislative action in 1974, followed the compact’s formula until 1993, when the state’s legislature passed a bill that modified the existing formula, resulting in higher taxes for out-of-state companies. Gillette, Proctor and Gamble and other multi-state companies that conduct business and pay taxes in California challenged the legality of this action in 2010.

In a unanimous ruling in the case, The Gillette Company v. The Franchise Tax Board, California’s First District Court of Appeals concluded, “because the Compact is both a statute and a binding agreement among sovereign signatory states, having entered into it, California cannot, by subsequent legislation, unilaterally alter or amend its terms.”

In response to the initial lawsuit filed by Gillette, California lawmakers decided to withdraw from the Multistate Tax Compact effective June 2012. In order to withdraw from the compact, the state had to amend existing statute through legislation.

While the case primarily addressed California’s method of collecting and allocating tax dollars from companies that do business across state lines, it brought into question a state’s ability to unilaterally amend the terms of a compact it has joined.

The Significance for Interstate Compacts
Despite California’s decision to withdraw from the compact, the court’s ruling represents a significant victory for states broadly and interstate compacts specifically. In the decision, the court seems to indicate that an interstate compact, even one without Congressional consent, trumps conflicting state law based upon the Contract Clause of the U.S. Constitution. For states that elect to join an interstate compact, the compact takes legal precedence over conflicting state laws, even cases in which the state law was passed more recently.

Just as importantly for interstate compacts, the court’s ruling seems to preclude a state from unilaterally modifying the terms of a compact, as long as it is part of existing state law. Interstate compacts are governed by the tenets of contract law and function as contracts between the states. As such, The Council of State Governments’ National Center for Interstate Compacts, along with compact experts, have always contended that a state cannot unilaterally modify the terms of an interstate compact. The ruling by the California Appeals Court clearly supports that contention.

The ruling also suggests that all member states of a compact are equal. While interstate compacts inhibit a state’s ability to act unilaterally, they allow states to work together to maintain collective sovereignty.
The notion of collective sovereignty is maintained by the appellate court ruling and is another significant advantage provided to states by interstate compacts.

Potential Impact
While the court’s ruling is an undeniable victory for interstate compacts, California’s decision to withdraw from the Multistate Tax Compact does raise concerns about the compact’s long-term viability. Other states could follow California’s lead and withdraw from the 60-year-old compact in an effort to collect additional tax revenue and prop up sluggish state budgets.

What cannot be denied, however, is the significance of the court’s ruling on interstate compacts in broad terms. With more than 215 interstate compacts in existence across the country, and most states belonging to more than 20 different agreements, the impact of this ruling extends far beyond California and the Multistate Tax Compact. By making it clear that a state cannot unilaterally amend the terms of a compact, the court has sent a clear indication about the strength, durability and sustainability of interstate compact.

REFERENCES

CSG RESOURCES
» National Center for Interstate Compacts
» Compacts Database

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For more information on why this ruling is important to states, watch Crady deGolian’s video on YouTube. http://knowledgecenter.csg.org/drupal/content/ncic-director-crady-degolian-discusses-key-legal-victory-interstate-compacts

Significant Compact Rulings
The recent ruling by the California First District Court of Appeals in the case of The Gillette Company v. The Fair Tax Board is being viewed as a significant victory for states generally and interstate compacts specifically. While the case represents the most recent court ruling on the topic of compacts, it is not the only one. Some significant rulings include:
• The Gillette Company v. The Franchise Tax Board
• The United States of America v. Jason Pleau
• Alabama et. all v North Carolina
• US. Steel Corp v. Multistate Tax Commission