Public Law 86-272: Sunlight for a Cloud Service

by Martin I. Eisenstein and Nathaniel A. Bessey

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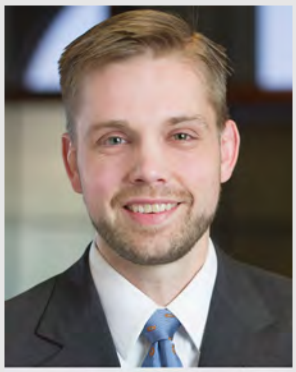

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In this edition of Eyes on E-Commerce, the authors argue that Public Law 86-272 provides an independent limit on states' ability to impose net income tax on out-of-state providers of cloud-based and other IT services if the provider does not conduct in-state business activities.

Multistate companies with several offices, or with a distributed workforce of home-office employees, are increasingly turning to cloud-based technology solutions as well as IT monitoring and help desk services for their computing needs. Cloud providers offer their customers consistent and reliable IT and software services across the workplace environment, including software applications, remote system monitoring, and help desk support. Because cloud-based services are provided in the cloud, customers can access those services from anywhere in the world, although the service providers' servers — or the persons providing monitoring and help desk support — may be physically located in one or more data centers and offices in a different state, or perhaps a different country, from the customers who use the services.

We have discussed the problems inherent in characterizing a cloud computing transaction and in sourcing IT services for sales and use taxes and other transaction taxes.[1] In this article we focus on questions regarding taxes on the net income of providers of cloud services and IT monitoring services, and specifically any potential limitations on a state's taxing authority. We argue that in addition to the traditional constitutional limitations under the commerce and due process clauses, Public Law 86-272, which refers to "business activities within the state," requires actual in-state activity by a provider of cloud services — potentially beyond the threshold requirements of those clauses.

I. Taxation of Software and Cloud Computing Transactions

Computer software is fundamentally data or information — the computer programs that run on computer equipment (hardware). Sales of pre-written computer software are subject to sales tax

[1] *See* Martin I. Eisenstein and Barbara J. Slote, "Let the Sunshine in: The Age of Cloud Computing," *State Tax Notes*, Nov. 28, 2011, p. 573; Eisenstein and David W. Bertoni, "Taxing Thin Air: Cloud Computing Meets Limitless Jurisdiction," *State Tax Notes*, Feb. 8, 2016, p. 407; and Eisenstein and Bertoni, "Here, There, and Everywhere: Constitutional Limits on IT Sourcing," *State Tax Notes*, Nov. 27, 2017, p. 805.

in most states, although some states distinguish between software sold on a tangible medium, such as a DVD, and software otherwise made available to the customer.[2] Unlike sales of pre-written software, cloud computing transactions typically do not involve the installation of software on an end user's computer. Rather, the cloud services provider will host applications or make IT infrastructure available to its customers over the internet; the software itself is hosted on the service provider's servers. For purposes of this article, we will focus on several types of cloud computing services: software as a service (SaaS), infrastructure as a service (IaaS),[3] and remote network and desktop monitoring and help desk services.[4]

II. Limitations on Income Taxation

The U.S. Constitution limits a state's power to impose tax obligations on an out-of-state company under the due process and commerce clauses. Under the due process clause, there must exist "some minimum connection, between a state and the person, property or transaction it seeks to tax," and the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing State."[5] In determining whether that minimum connection exists, courts will inquire "whether a defendant had minimum contacts with the jurisdiction such that the maintenance of the suit does not offend traditional notions of fair play and substantial justice."[6] That inquiry is often characterized as asking whether the state has provided a benefit to the out-of-state company for which it can demand something in return. It is "defendant's contacts with the forum state itself, not the defendant's contacts with the persons who reside there" that create the minimum contacts.[7] Therefore, it may well be the case that the due process clause alone provides a strong defense to a state's imposition of income tax liability on a cloud service provider located outside its borders.

The commerce clause[8] delegates to Congress the power "to regulate Commerce . . . among the several States." The U.S. Supreme Court has clarified under its dormant commerce clause jurisprudence that this grant of congressional authority impliedly prohibits states from imposing taxes or taking other action that interferes with interstate commerce.[9] The test for whether a tax violates the dormant commerce clause was articulated in *Complete Auto Transit Inc. v. Brady*,[10] which held that a state tax is permissible if it (1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. Of course, in the pending *Wayfair* case[11] the Court is addressing South Dakota's argument that economic presence is sufficient to establish substantial nexus for sales tax purposes. Regardless of the case's outcome, we believe that P.L. 86-272 (in addition to the due process clause) gives a cloud service provider a good basis to abate any net income tax assessment by a state based on the provider's merely having customers located in the state.

P.L. 86-272, enacted in 1959 as the Interstate Commerce Tax Act,[12] provides that:

> No State, or political subdivision thereof, shall have power to impose . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business

[2] Every state with a sales tax on tangible personal property taxes pre-written software when the purchaser receives the software on a tangible medium. Most states also tax sales of pre-written computer software when it is downloaded by the customer, although some only tax the tangible form (for example, Arkansas, California, Colorado, Florida, Georgia, Idaho, Iowa, Maryland, Missouri, Nevada, Oklahoma, South Carolina, and Virginia), and do not tax downloaded software.

[3] SaaS provides access to software and applications owned and hosted on the provider's servers. Those servers are generally housed at data centers, frequently outside the state of a given user of the SaaS product. IaaS provides access to storage and IT computing resources on the provider's computers. The servers are typically located at a data center maintained by the provider.

[4] While monitoring and help desk services are often provided as a separate service by IT service providers, there are some cloud service providers who do provide monitoring/help desks for networks and desktops to allow subscribers to the cloud service to access the software and infrastructure housed remotely from the desktops.

[5] *Quill v. South Dakota*, 504 U.S. 298, 306 (1992).

[6] *Id.* at 307 (citing *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945)).

[7] *Walden v. Fiore*, 134 S. Ct. 1115, 1122 (2014).

[8] U.S. Const. Art. 1 section 8, clause 3.

[9] *Quill*, 504, U.S. at 309.

[10] 430 U.S. 274, 279 (1977).

[11] *South Dakota v. Wayfair Inc.* No. 17-494.

[12] 15 U.S.C. section 381.

activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

1. the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property (TPP), which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
2. the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).[13]

Importantly, P.L. 86-272 prohibits taxation of business income in circumstances in which taxation would otherwise be permitted under either the commerce clause or the due process clause.[14] Accordingly, courts typically analyze the application of P.L. 86-272 only after considering the constitutional questions, and P.L. 86-272 case law typically involves an examination of an out-of-state business's in-state business activities to determine whether they amount to mere solicitation of TPP (protected activities), in which case the imposition of income tax is prohibited by the federal law, or if they go beyond mere solicitation (unprotected activities), in which case the tax is permitted.[15] The Supreme Court has also said that a state's income tax will not apply to a taxpayer whose in-state activities, even if technically unprotected under P.L. 86-272, are merely de minimis.[16]

III. P.L. 86-272 Limitations on Power to Tax Cloud Computing

As noted, many states consider software to be TPP. If a state's definition for sales tax purposes of TPP is adopted,[17] solicitation of sales in the state of software in interstate commerce should qualify as protected activities under P.L. 86-272, and out-of-state sellers of software should be immune from taxation under P.L. 86-272, so long as their in-state activities do not exceed solicitation. But what of cloud computing transactions? Depending on a state's laws, SaaS transactions may be considered either services or sales of software (for example, sales of TPP, to the extent software is considered TPP regardless of medium); IaaS transactions may be characterized as either a data processing service or as a lease of computer equipment, to the extent the customer is being provided with storage and server space; and remote monitoring will be considered a service. How, if at all, does P.L. 86-272 apply to income derived from sales of those products?

[13] *Id.*

[14] P.L. 86-272 was enacted in response to the Supreme Court's 1959 decision in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). In that case, a cement company in Iowa, near the Minnesota border, engaged in "a regular and systematic course of solicitation of orders for the sale of its products" by sending sales representatives across the border into Minnesota. The Supreme Court held that, under those circumstances, a tax on the net income derived from sales to Minnesota customers did not unconstitutionally burden commerce. Under P.L. 86-272, passed by Congress that same year, such solicitation activities, without more, cannot be the basis for the imposition of state tax on a business's net income from interstate commerce.

[15] The Multistate Tax Commission's "Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272" provides a list of activities the MTC signatory states will continue to regard as protected and unprotected under P.L. 86-272.

[16] *See Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 228, 232 (1992) (P.L. 86-272 protection for solicitation attaches to those activities that are "entirely ancillary to requests for purchases — those that serve no independent business function apart from their connection to the soliciting of orders." The test for whether in-state activity other than solicitation of orders will be considered more than de minimis — sufficient to forfeit P.L. 86-272's immunity — is whether the in-state activity "establishes a nontrivial additional connection with the taxing State").

[17] P.L. 86-272 does not define TPP, leaving open the possibility that a state's definition of the term could determine whether in-state solicitation activities are protected under P.L. 86-272. *See AccuZIP Inc. v. Director, Division of Taxation*, 25 N.J. Tax 158, 171 (N.J. Tax Court 2009) (looking to New Jersey's tax laws, as well as U.S. Treasury Regulations, to conclude that pre-written software is TPP, and solicitation is protected under P.L. 86-272).

Some have pointed out the tension inherent in using state definitions of TPP, which are not uniform, when applying P.L. 86-272, a federal statute enacted under the commerce clause to protect a nationwide market, which should presumably be interpreted consistently across the country. *See* Rick Handel, "A Conceptual Analysis of Nexus in State and Local Taxation, 67 *Tax Law* 623, 704, Summer 2014. For purposes of this article, we need not resolve this tension.

P.L. 86-272 is sometimes said to apply only to a seller of TPP, and not to a seller of services.[18] That is an incorrect reading of the statute, however. P.L. 86-272 limits the categories of protected activities to solicitation of sales of TPP in a state,[19] but it does not limit the categories of income from interstate commerce that are immune from taxation. In other words, it does not follow that if a company sells services, but engages in no activities in a state, the state has the power to tax income arising from those sales.

We believe that in adopting P.L. 86-272, Congress implicitly exempted from the reach of state tax any income arising from activities occurring entirely outside a state, and therefore preempted any state law that taxes the income of an out-of-state company absent in-state activity by that company. When Congress exercises its regulatory authority in a particular area — in this case the taxation of interstate commerce — under the supremacy clause of the Constitution, federal law preempts state law to the extent the state law is inconsistent with the federal law.[20] Although courts are careful not to extend preemption beyond the evident scope of a federal statute,[21] they will give a statute the full preemptive effect intended by Congress.[22] Congressional intent can be "explicitly stated in the statute's language or implicitly contained in its structure and purpose."[23] Congress's intent in adopting P.L. 86-272 is revealed in both its explicit language and in its structure and purpose.

The first Supreme Court case to interpret P.L. 86-272 was *Heublein*, in which the Court noted that P.L. 86-272 was "designed to define clearly a lower limit" for the exercise of state taxing power.[24] Further, "by establishing such a limit, Congress did, of course, implicitly determine that the state's interest in taxing business activities below that limit was weaker than the national interest in promoting an open economy."[25] The business activities of a company that has no in-state activities necessarily fall below the lower limit of in-state activities established by Congress, and that company is the beneficiary of Congress's grant of exemption from state income-taxation.

This conclusion also flows from Congress's actual language, as well as long-established principles of federalism. P.L. 86-272 established categories of in-state business activities that an out-of-state company may engage in, without forfeiting the exemption from taxation conferred by the statute. By implication, in-state business activities themselves are a necessary predicate for state taxing authority. Also, courts have consistently recognized the limits on a state's power to regulate beyond its borders.[26]

[18] *See Tax Commissioner of State v. MBNA America Bank NA*, 220 W. Va. 163, 166; 640 S.E.2d 226, 229 (W. Va. 2006), n. 6 (identifying P.L. 86-272 as an example of Congress's regulation of interstate commerce, and referencing unsuccessful attempts "to amend 15 U.S.C. [section] 381 to apply to, in addition to tangible property, all other forms of property, services, and other transactions fulfilled from a point outside the state." In fact, the bills would have expanded the list of protected solicitation activities to include solicitation of services. No amendments were proposed to alter the scope of P.L. 86-272's exemption, when applicable – the exemption would continue to apply to *all* "income derived within such state . . . from interstate commerce," provided in-state activities did not exceed protected activities. *See* H.R. 1956, 109th Congress (Apr. 28, 2005); H.R. 4845, 109th Congress (Mar. 2, 2006); and S. 2721, 109th Congress (May 4, 2006)).

[19] That means that a sales force selling TPP can solicit sales in-state without forfeiting P.L. 86-272's tax immunity, but a sales force selling services cannot.

[20] U.S. Const. Art. 6, cl. 2; *M'Culloch v. Maryland*, 17 U.S. 316, 427 (1819) (state law that conflicts with federal law is "without effect").

[21] The MTC has recognized this principle in its Statement of Information, *supra* note 15, stating that "in those cases where there may be reasonable difference of opinion whether the disputed activity exceeds what is protected by P.L. 86-272, the signatory States will apply the principle that the preemption of state taxation that is required by P.L. 86-272 will be limited to those activities that fall within the 'clear and manifest purpose of Congress.'" *See Department of Revenue of Oregon v. ACF Industries Inc.*, 510 U.S. 332, 114 S.Ct. 843, 127 L. Ed.2d 165 (1994);*Cipollone v. Liggett Group Inc.*, 505 U.S. 504, 112 S.Ct. 2608, 120 L. Ed.2d 407, 422 (1992); and *Heublein Inc. v. South Carolina Tax Com.*, 409 U.S. 275, 281-282 (1972).

[22] *Cipollone v. Liggett Group Inc.*, 505 U.S. 504, 516 (1992) ("The purpose of Congress is the ultimate touchstone of pre-emption analysis") (internal citations omitted).

[23] *Id.* (*citing Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977)).

[24] *Heublein v. South Carolina Tax Com.*, 409 U.S. 275, 280 (1972). This conclusion was repeated in *Wrigley*, 505 U.S. at 223.

[25] *Heublein*, 409 U.S. at 280. In reaching this conclusion, the Court cited the congressional record, which indicated concern with "the inescapable fact that compliance with the diverse tax laws of every jurisdiction in which income is produced will require the maintenance of records for each jurisdiction and the retention of legal counsel and accountants who are familiar with the tax practice of each jurisdiction." *Id.* at n. 6 (citing H.R. Rep. 936, 86th Congress, 1st Session, p. 2).

[26] *See Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945) (striking down state law in which the "practical effect of such regulation is to control [conduct] beyond the boundaries of the state."); *Shaffer v. Heitner*, 433 U.S. 186, 197 (1977) ("any attempt 'directly' to assert extraterritorial jurisdiction over persons or property would offend sister States and exceed the inherent limits of the State's power"); and *Edgar v. MITE Corp.*, 457 U.S. 624, 642-644 (1982) ("the State has no legitimate interest in protecting nonresident[s]").

Read in light of its structure and purpose, and paying close attention to its language, P.L. 86-272 must be understood as standing for the following proposition: Income derived from interstate commerce is prima facie immune from state taxation, unless a company's activities in the taxing state are sufficient to provide a taxing nexus. Engaging in P.L. 86-272-protected solicitation activities does not create the tax immunity; rather, in deeming solicitation activities protected, Congress defined a category of in-state activity that might otherwise be nexus-creating, but that it deemed worthy of protection, in order to avoid undue burdens on interstate commerce. It stands to reason, then, that just as a taxpayer whose in-state business activities exceed the protected solicitation activities would not be entitled to P.L. 86-272's immunity from taxation, Congress clearly intended that a taxpayer with no in-state activities would be entitled to that immunity, just as a taxpayer that engaged only in solicitation would be.[27]

The key question regarding the applicability of P.L. 86-272, then, is not only how the product being sold is characterized, but rather the nature of the seller's in-state business activities, if any. A discussion of the three types of cloud computing transactions illustrates this point.

A. SaaS

In an SaaS transaction, the customer pays for access to applications or software hosted on servers owned by the service provider, located in a data center. In our hypothetical the seller may have offices in State A, and may have servers in states B and C. The seller does not have any property or payroll in any other states. The customer is a large company with employees working from home offices in all 50 states. The seller's sales representatives visit the customer's headquarters in State D, and the seller secures a contract to provide an SaaS product available to all of the customer's employees. Payment under the contract is based on the number of users, and there are users in all 50 states. Which states may impose a tax on seller's net income?

First, the seller may be subject to income taxation in states A, B, and C — where the seller engages in activities and has a physical presence in the form of property and payroll. Such tax must be fairly apportioned among the states. Second, the seller may have nexus with State D on the basis of the sales reps' trips to the customer's headquarters in that state. Thus, to the extent the SaaS product is characterized as a service, the solicitation activity will not be protected, and seller will be subject to tax in State D.

To the extent the SaaS product is considered TPP, however, the sales reps' solicitation activities are protected under P.L. 86-272, and the seller's income is immune from state taxation by State D. As for all other states, our view is that they should be prohibited from imposing a tax on the seller's net income under the given facts, because the seller engaged in no in-state business activities, solicitation or otherwise. No representatives visited or traveled to any states other than A, B, C, or D, and the seller never maintained property in any other state. Rather, the software was made available on hosted servers located out of state.

A user in State E may access the SaaS application from a terminal in State E. State E's apportionment rules may call for the receipts from sales of SaaS products used by users in more than one state to be sourced based on the end user's location. But none of that amounts to in-state activity by the seller. Accordingly, the affirmative grant of immunity from income taxation provided by Congress in P.L. 86-272 should continue to apply. Under that hypothetical, seller would have a good argument under the due process clause as well, unless the state were able to establish that the seller engaged in a pattern of activities outside the state directed at soliciting business in State E.

B. IaaS

In an IaaS transaction, the customer pays a subscription fee and obtains access to IT infrastructure, including computing power and cloud storage. If we assume the same facts as the

[27] Indeed, as *Heublein* made clear, P.L. 86-272 was enacted to provide certainty to businesses engaged in interstate commerce who were "in doubt as to the amount of local activities within a State that will be regarded as forming a sufficient 'nexus,' that is, connection, with the State to support the imposition of a tax on net income from interstate operations and 'properly apportioned' to the State." *Id.* at n. 4 (citing S.Rep. No. 658, 86th Cong., 1st Sess., 2, U.S. Code Cong. & Admin. New 1959, p. 2549). Further, in *Wrigley* the Court recognized a de minimis exception even for activities that went beyond the protected activities. *Wrigley*, 505 U.S. at 231.

SaaS example, we conclude that states A, B, and C may tax seller's income from sales of IaaS to the customer, to the extent that income is fairly apportioned to the states. Whether State D may impose the tax will depend on the characterization of the IaaS product; to the extent the IaaS product is considered a data-processing service, which it is likely to be, State D will be permitted to impose its tax on the seller's net income attributable to State D, because solicitation of services (rather than TPP) is not a protected activity under P.L. 86-272.

As for all other states, the question is whether the seller has engaged in any in-state activity sufficient to overcome the implicit immunity conferred by P.L. 86-272. Permitting a terminal in State E to connect to a web server in an out-of-state data center does not seem to us to be a business activity of seller in State E. For that reason, the immunity of P.L. 86-272 should apply.

C. Remote Monitoring

Many providers of cloud services also offer remote monitoring services to their customers. Under a contract for that type of service, a provider will continually monitor the performance of a customer's network and IT systems and often remotely diagnose, fix, make changes to, and patch software on servers, desktops, printers, laptops, and mobile devices. The customer's workstations and other infrastructure may be located in various states, but the services are provided from a central location that is not where the users are located; by definition remote monitoring is done from another location.

In some cases, a service provider may not know the exact location of every piece of equipment in a monitored network, and monitoring services often cover mobile workstations for employees who travel and may benefit from monitoring and support in multiple states. As we have discussed elsewhere,[28] that type of IT service is beset by serious problems of sourcing: Should services be sourced based on the location of the provider's servers, the location of the customer's individual workstations, the customer's headquarters, or some combination thereof[29] (assuming all of those locations are known to the provider)? And does the provider have an obligation to determine the actual location of each user on the network?

If a service provider does not know the state where a user accesses or benefits from monitoring services, imposition of state income tax solely on the basis of the user's presence in the state is unlikely to satisfy the due process clause. Even if the location is known and that provides a basis for due process jurisdiction, which is debatable, we believe that P.L. 86-272 provides a defense to the imposition of an income tax when the service is all performed remotely and the service provider itself performs no activities within the taxing state.

IV. Conclusion

The Constitution grants Congress the authority to regulate interstate commerce. From that exclusive grant of federal authority, the Supreme Court has articulated the concept of the dormant commerce clause — impliedly prohibiting states from imposing taxes that burden interstate commerce absent a substantial nexus, even in areas in which Congress has not acted. When Congress affirmatively acts to regulate interstate commerce, as it did when it passed P.L. 86-272, it necessarily preempts state regulation to the contrary. P.L. 86-272 embodies the congressional determination that the needs of interstate commerce require that income from interstate commerce is exempt from state taxation, absent some in-state business activity. Put another way, there can be no state income taxation in the absence of in-state activity. The mere fact that income from interstate commerce might be apportioned to a given state under that state's sourcing rules does not itself amount to an in-state business activity.

[28]Eisenstein and Bertoni, "Here, There and Everywhere," *supra* note 1.

[29]One possible sourcing approach would be to use the analogue of interstate telephone service. Under the Supreme Court's seminal ruling in *Goldberg v. Sweet*, 488 U.S. 252, 263 (1989), interstate telephone service can be subject to tax (1) in the state where the call originates or terminates and the service address is located; or (2) in the state where the call originates or terminates and the billing address is located.

That principle has relevance to cloud-based services, for which questions of sourcing and location are uniquely problematic. It is true that some courts have upheld state income taxes imposed on taxpayers who lacked a physical presence in the state, based on other theories such as economic nexus[30] or presence of intangibles — such as licensed trademarks — in the state.[31] The trademark licensing cases may be distinguished on the ground that there is some in-state activity that generates sales in state, which is the basis of the licensor's income. By contrast, a cloud services provider simply makes its services available on the internet; where they are accessed from[32] is of no moment to the cloud provider. That should also be the case for states basing income tax nexus on economic nexus.

Providers of cloud services in interstate commerce must be aware of their actual in-state activities (including the location of their property and data centers and the activities of agents and independent contractors on their behalf) and must recognize that those activities can easily subject them to income taxes on income derived from sources within any state with nexus. To the extent providers do not have any in-state activities, however, it was Congress's intent that they be shielded from state income taxation by that state. ■

[30] *See, e.g. Tax Commissioner of State v. MBNA America Bank NA*, 220 W. Va. 13, 172, 640 S.E.2d 226, 235 (W.Va. 2006) (rejecting physical presence standard for imposition of income tax, finding substantial nexus based on significant gross receipts from West Virginia customers, and a finding that MBA "continuously and systematically engaged in direct mail and telephone solicitation and promotion in West Virginia").

[31] *See, e.g. Geoffrey Inc. v. Commissioner of Revenue*, 453 Mass 17, 19, 899 N.E.2d 87, 89 (Mass. 2009) (describing taxpayers business activities as licensing trademarks for use in Massachusetts).

[32] A potential further sourcing wrinkle occurs when a multistate customer uses an SaaS or IaaS product to provide services to its own customers. In that circumstance, the benefit of the service is arguably received not in the state where it is located, and not in the state where the customer's workstation sits, but in the state where the customer's customer is. That state would be two degrees removed from any in-state business activity of the cloud services provider, and it should be barred from imposing a net income tax on the proceeds of the cloud transaction, regardless of the dollar amount.