Wayfair and P.L. 86-272 in a Services Economy

by Martin I. Eisenstein and Nathaniel A. Bessey

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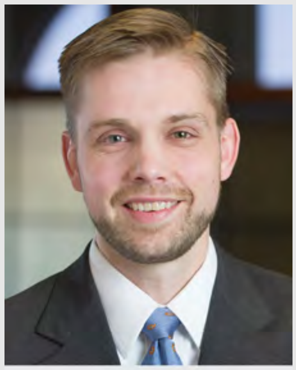

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In this installment of Eyes on E-Commerce, the authors discuss the statutory and constitutional protections from unduly burdensome state taxation available to service providers engaged in interstate commerce in the wake of the Supreme Court's recent *Wayfair* decision.

In the May 21 issue of *State Tax Notes*, we asserted that P.L. 86-272,[1] the Interstate Income Tax Act of 1959, immunizes a cloud services provider from a state's income tax if the company conducts no activities in the state. Since that article was published, there has been a sea change in the commerce clause nexus standard for sales tax collection. On June 21 the U.S. Supreme Court issued its opinion in *South Dakota v. Wayfair Inc.*[2] The Court abrogated the physical presence test of substantial nexus, as set forth in *Quill Corp. v. North Dakota*,[3] and replaced it with an economic presence test.

As we predicted in the prior article, *Wayfair* does not affect the P.L. 86-272 test, but it certainly underscores that a provider of services must consider the applicability of this federal statute for state income taxes in jurisdictions outside its home state. In this article, we discuss the applicability of P.L. 86-272 and the constitutional tests under the commerce clause and due process clause to providers of services in the aftermath of the *Wayfair* decision.

A Word About the Services Economy

It is common to say that the United States is in a services economy.[4] Much like the movement in the 19th and early part of the 20th centuries from an agricultural to a manufacturing economy, so too have the last 60 years seen a trend toward services becoming an increasingly greater part of the country's

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[1] 15 U.S.C. section 381.

[2] 138 S. Ct. 2080 (2018).

[3] 504 U.S. 298 (1992).

[4] A services economy is defined as an economy that depends primarily on providing and selling services such as banking, transportation, legal, and marketing rather than on producing goods or agricultural products. *See* Lexicon of the *Financial Times*.

economic output.[5] That trend does not mean, however, that in 1959, when P.L. 86-272 was enacted, services were not an important part of the economy.[6] Indeed, there are several reported decisions rendered before 1959 that addressed state taxation of the income of a services provider.[7] We discuss one of those cases in the following section.

The fact that the economy in the early part of the 20th century was tied to the manufacture and sale of goods did play a major role in the scope of the sales tax laws. Thus, the sales tax laws, the majority of which were adopted between 1932 and 1935, primarily tax the sale of tangible personal property.[8] Only a handful of states, such as Hawaii, New Mexico, and South Dakota, impose sales tax on services in general, while the vast majority of states impose sales tax only on selected services. Thus, as we have written in other contexts, when states started taxing software they often did so on the basis of characterizing the software, if it had been prewritten, as tangible personal property.[9] Similarly, sourcing a sale for sales tax purposes is primarily based on where the tangible personal property is delivered. Many services are difficult to source, however, based on the delivery point of the service. For example, where is software as a service (SaaS) delivered? At the point where the provider's server is located and from which the customer retrieves or uses the software? Or is it where the customer realizes the benefit of the service, and if so, how is that location determined? As we discuss below, sourcing of services is a factor in determining whether a state exceeds, in the words of the *Wayfair* Court, "the boundaries of a State's authority to regulate interstate commerce."[10] Those boundaries are in turn based on two fundamental principles: the state tax must not discriminate against nor place an undue burden on interstate commerce.[11]

The Case for P.L. 86-272 Providing Protection For Services Providers

Our argument that P.L. 86-272 protects the income of a service provider from state income tax if the provider does not perform any activities in the state drew substantial criticism, in the nature of an opposition brief, from Richard Cram of the Multistate Tax Commission, especially in light of the Supreme Court's decision in *Wayfair*.[12] We present in this section the basis for our argument that the federal statute should protect the income of a service provider from state taxation, and in the following section we discuss why the *Wayfair* decision should have no effect on the analysis under P.L. 86-272. While we will not address each argument Cram made in his article, since this is not a reply brief, it is worthwhile to discuss some of his major points.

First, although Cram argues that commentators assert that P.L. 86-272 places limitations on state taxation of net income *from the sale of tangible personal property*, the text of the statute does not limit the basis for the net income of the out-of-state company. It states that "[n]o State, or political subdivision thereof, shall have the power to impose . . . a net income tax on the income derived from *interstate commerce*" if the only business activities within such State by or on behalf of such person during such taxable year are protected solicitation activities.[13] Cram would revise the statutory language to say that a state may not impose "a net income tax on the income derived from *the sale of tangible personal property in* interstate commerce." In other words, he would add the term "the sale of tangible personal property" to this clause. The sole reference to the

[5] In 2017 employment for services accounted for 79.45 percent of the jobs in the United States, while the manufacturing and industrial sector employed 18.89 percent of the total employees in the United States. *See* World Bank Open Data.

[6] Services accounted for 14.1 percent of total employment in 1959, when P.L. 86-272 was enacted. *See* Valerie A. Personick, "A Second Look at Industry Output and Employment Trends Through 1995," *Monthly Labor Review* 26 (1985).

[7] *ET & WNC Transportation Co. v. Currie*, 248 N.C. 560, 104 S.E.2d 403 (1958), *judgment aff'd*, 359 U.S. 28 (*per curiam* 1959); and *Norfolk & Western Railway Co. v. North Carolina*, 297 U.S. 682 (1936).

[8] The sales tax was the product of the Depression. Mississippi was the first state to enact a sales tax, in 1932, and several other states quickly followed Mississippi's lead, so that by 1935 more than half the states had adopted sales taxes. Walter Hellerstein et al., *State and Local Taxation Cases and Materials* (2014).

[9] *See* Martin Eisenstein and Michael Carey, "Transaction Taxes on Information Technologies: The Threat," *State Tax Notes*, Dec. 22, 2014, p. 689.

[10] 138 S. Ct. 2080 (2018).

[11] *Id.*

[12] *See* Richard L. Cram, "No Shade for Cloud Computing Income Under P.L. 86-272," *State Tax Notes*, Sept. 24, 2018, p. 1237.

[13] 15 U.S.C. section 381 (emphasis added).

sale of tangible personal property in the statute relates only to the nature of the activities an out-of-state taxpayer may conduct in the state without sacrificing the P.L. 86-272 immunity. The protected activities are "the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property."[14] But the conflation of the two separate clauses in the statute is not warranted under sound principles of statutory construction.[15] We are reminded of Justice Felix Frankfurter's three fundamental principles of statutory construction: "(1) Read the statute; (2) read the statute; (3) read the statute!"[16]

Second, immediately before the enactment of P.L. 86-272, there were several Supreme Court decisions that formed the basis for the approach found in the law. In *Northwestern States Portland Cement Co. v. Minnesota*,[17] the Court sustained a Minnesota income tax of an Iowa manufacturer whose only activity in Minnesota was the solicitation of orders for the sale of tangible personal property in Minnesota. Within one week of that decision, the Court both dismissed the appeal of, and refused certiorari to review, a Louisiana Supreme Court decision that sustained an assessment of the state's net income tax on a company whose representatives called on wholesalers in Louisiana but did not solicit sales there. *Brown-Forman Distillers Corp. v. Collector of Revenue*.[18] On the same day, in its very next decision, the Supreme Court affirmed per curiam the North Carolina decision in *ET & WNC Transportation Co. v. Currie*,[19] based on the *Northwestern Portland Cement Co.* decision. In *ET & WNC Transportation Co.*, the North Carolina Supreme Court sustained a state income tax on a transportation services company for two reasons: the company rented and used freight terminals in various locations in the state, where it maintained company-owned trucks as well as furniture and fixtures; and it transported products to and from North Carolina locations.[20] As one commentator put it, these decisions of the Supreme Court caused businesses to advocate to Congress for a limitation on the broad sweep of these decisions.[21] In response, Congress held hearings in which businesses asked it to "establish clear guidelines as to the amount of activity within a State that was necessary to expose them to liability for net income taxes."[22]

The House and Senate proposed different bills to limit the states' power to impose income taxes. Both bills prohibited a state's imposition of a tax on the income of any business engaged in interstate commerce.[23] Neither bill was limited to the imposition of a tax on income from the sale of tangible personal property. Both bills contained "a minimum activities approach to the problem of state taxation of income from interstate commerce."[24] The purpose of both bills was "to specifically exempt, from state taxation, income derived from interstate commerce where the only

[14] 15 U.S.C. section 381(a)(1).

[15] If the basis for the exclusion for P.L. 86-272 immunity were the type of income that the company generated rather than the in-state activity, how would P.L. 86-272 apply to a company that derives income from both the sale of property and services? Would a manufacturer of watches that also receives payment for repairs not be entitled to the exemption? Would we read into P.L. 86-272 "a net income tax on the income derived *only from the sale of tangible personal property* in interstate commerce?" As the bill was debated in Congress, there was discussion whether the word "primarily" should be used instead of "only." When the bill became law, the word "only" was used, but to describe the limitation of in-state activities in the state. Thus, the statute provides immunity "if the *only* business activities within such State by or on behalf of such person . . . are the solicitation of the sale of tangible personal property." 105 *Cong. Rec.*, Part 13, 16384-16387 (1959) (emphasis added). As noted above, there is no limitation in the statute on the type of income that is exempt from state income taxation (for example, income from sales of tangible personal property versus income from sales of services) beyond the requirement that the income be derived from interstate commerce.

[16] 130 *Harv. L. Rev.* 1079, 1082 (2017), *quoting* Henry J. Friendly, *Justice Frankfurter and the Reading of the Statute*, in *Benchmarks* 196, 202 (1967) (in turn quoting Justice Frankfurter).

[17] 358 U.S. 450 (1959).

[18] 234 La. 651, 101 So.2d 70 (1958), *cert. denied and appeal dismissed*, 359 U.S. 28 (1959).

[19] 248 N.C. 560, 104 S.E.2d 403 (1958), *judgment aff'd*, 359 U.S. 28 (*per curiam* 1959).

[20] 248 N.C. 560, 576; 104 S.E.2d 403, 413 (1958).

[21] *See* Charles A. Trost, *Federal Limitations on State and Local Taxation 3d*, section 10:8 (2017).

[22] *Id.*

[23] The House bill, found in House Joint Resolution No. H.R.J. Res. 450, 86th Congress (1959), prohibited imposition of a net income tax "on the income of a business engaged in interstate commerce" unless, during the taxable year, the business "maintained an office, salable inventory, warehouse or other place of business in that State. See 105 Cong. Rec., Part 13, 16470 (1959). The Senate Bill contained the language now enshrined in the statute, which prohibits the imposition of a net income tax "on the income derived within such State by any person from interstate commerce if the only business activities within such state by or on behalf of such a person during the taxable year" are protected solicitation activities. S. 2524, 86th Congress (1959).

[24] *See* Statement of the Managers on the part of the House, Conf. Rep. No. 86-1103 (1959).

business activity within the state by the out-of-state company was solicitation."[25] The only difference was "the language used to accomplish this objective."[26] The House elected to accept the Senate version, which excluded income from interstate commerce from state taxation as long as the in-state activity did not exceed a minimum level, with the added limitation that the in-state solicitation of orders that would not trigger state income tax was restricted to the solicitation of orders *for sales of tangible personal property*.[27]

Third, the language of the House and Senate bills did not exclude the sellers of services from the protection of the legislation, as suggested by Cram in his article. The only exclusions in the bills from the immunity from state taxation of income were corporations incorporated in the state and individuals domiciled in or residents of the state.[28] Indeed, the final legislation excluded from the protection of state income taxes only domestic corporations and residents and citizens of the state.[29] As an additional principle of statutory construction, the failure to specifically exclude companies that sell services from the broad protections of the statute is another indication that such companies are given the same protections as sellers of tangible personal property.[30] This is particularly the case in the context of P.L. 86-272, since Congress was well aware of the taxation of a company whose income is derived from services through the decision in *ET & WNC Transportation Co.* What Congress did make clear, however, is that activities within the state that exceed the minimum standard of solicitation of the sale of tangible personal property, such as "servicing and maintenance, which is a very essential element of operation in a particular State," void the immunity from state taxation.[31] While it is true that, following the passage of P.L. 86-272, the Iowa manufacturer in *Northwestern Portland Cement Co.* was exempt from Minnesota state income tax, although the Tennessee transportation service provider in *ET & WNC Transportation Co.* was subject to North Carolina state income tax, this is not because the cement company sold tangible personal property and the transportation company sold services. Rather, it is because the service provider's contacts with North Carolina, including renting freight terminals and maintaining furniture and fixtures in the state, far exceeded the protected solicitation activities listed in P.L. 86-272. Congress did not choose to exclude companies earning income from services from protection from state taxes, but it did not afford the benefits of the legislation to companies that conducted in-state activities.[32] This would include service providers such as the trucking company in *ET & WNC Transportation Co.*, and also any seller of tangible personal property conducting in-state activities beyond solicitation.

Fourth, as the Supreme Court recognized in *Heublein Inc. v. South Carolina Tax Commission*,[33] P.L. 86-272 "was designed to define clearly a lower limit for the exercise of" a state's power to tax. By establishing that limit, Congress drew the line so that all activities below that limit did not void the protection from state income tax.[34] The line was drawn based on the nature of the activity in-state, and not on how the company generated income. This line drawing was an "accommodation of local and national interests," which is "a delicate

[25] *Id.* and 105 *Cong. Rec.*, Part 13, 16470.

[26] Conf. Rep. No. 86-1103, *supra* note 23.

[27] *Id.*

[28] S. Comm. on Finance, S. Rep. No. 86-658, at 2 (1959).

[29] 15 U.S.C. section 381(b).

[30] The presumption that "when a statute designates certain persons, things, or manners of operation, all omissions should be understood as exclusions" is recognized under the maxim *expressio unius est exclusio alterius*. *Copeland v. Ryan*, 852 F.3d 900, 906. The specific enumeration, in 15 U.S.C. section 381(b), of the categories of taxpayers who are excluded from the broad protections of P.L. 86-272 must be understood as meaning that only corporations incorporated in the state and domestic residents and citizens of the state are excluded from P.L. 86-272's protection, and all others are included.

[31] *See* Statement of Sen. Jacob Javits, 105 *Cong. Rec.*, Part 13, 16377.

[32] Cram cites to a law review article written by Robert L. Roland, who was the collector of revenue for Louisiana at the time the article was written, "Public Law 86-272: Regulation or Raid," 46 *Va. L. Rev.* 1172 (1960), as the basis for his argument that P.L. 86-272 was limited to net income derived from the sale of tangible personal property. Roland, however, drew that conclusion based on the nature of the activities provided by transportation companies such as railroads, buses, airlines, and motor vehicles, which "by their very nature require interstate movement" and hence conduct activities in the state. *Id.* at 1176. Roland was right that the nature of the activities of these transportation companies remove them from the protection of P.L. 86-272, but he was wrong to the extent he identified the basis for that exclusion as the source of the companies' income from interstate commerce (e.g. whether the income is derived from the sale of tangible personal property or from the sale of services), rather than the nature of the companies' in-state activities.

[33] 409 U.S. 275, 281 (1972).

[34] *Id.*

matter."[35] Moving the line arbitrarily so as to exclude income from services would disturb the balance Congress intended to achieve by the legislation.

Fifth, Cram seems to argue that because the language of P.L. 86-272 does not say that activities conducted solely outside the state preclude state taxation that a state is allowed to impose a tax on net income. But that argument proves too much. Under the logic of that argument, solicitation of sales from outside a state of tangible personal property would cause a company to void its P.L. 86-272 protection even though the very same activity within the state would not void the protection. As the Court stated in *Heublein*, by establishing the limit of in-state activities consisting of solicitation of the sale of tangible personal property, "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."[36]

Sixth, Cram misunderstands the doctrine of preemption under the supremacy clause. It is true that under the supremacy clause, Congress will not be deemed to strike down a state statute designed to protect the public health and safety "unless its purpose to do so is clearly manifested."[37] A state law will be superseded, however, if the law as applied "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[38] The purpose of P.L. 86-272 is clear, both from the language of the statute and the legislative history: To provide immunity from state tax for all net income from interstate commerce so long as the minimum levels of activities specified in the law — the in-state solicitation of orders for tangible personal property by the company or representatives — are not exceeded. When such minimum activity is exceeded, as was the case in *Heublein*, then the state tax survives. On the other hand, a state's taxation of income, regardless of its source, based on activities that fall below that level would "frustrate the objectives" of P.L. 86-272.[39]

Wayfair Does Not Change the Analysis Under P.L. 86-272

We agree with Cram that the implication of the *Wayfair* decision is that economic presence, as opposed to physical presence, satisfies the substantial nexus requirement under the commerce clause. In particular, the *Wayfair* Court applied the *Complete Auto Transit Inc. v. Brady*[40] four-prong test, which as the Court stated is the test for measuring the constitutionality of *all* state taxes under the dormant commerce clause.[41] The Court held that the first prong — the tax applies to an activity with substantial nexus with the taxing state — is established when the taxpayer "'avails itself of the substantial privilege of carrying on business' in that jurisdiction."[42] In turn, nexus was "clearly sufficient based on both the economic and virtual contacts respondents have with the State."[43] So what is good for the goose for sales tax is certainly good for the gander for other state taxes, such as income taxes and gross receipts taxes, if the pertinent state statute bases nexus on "factor presence."[44]

The fact that *Wayfair* permits a state tax to survive a commerce clause challenge based on mere sales alone, however, does not affect whether the state may impose an income tax under P.L. 86-272. It is important to remember that P.L. 86-272 has always provided immunity from income taxation to out-of-state companies that

[35] *Id.*

[36] 409 U.S. at 281.

[37] *Southern Pacific Co. v. Arizona*, 325 U.S. 701, 766 (1945).

[38] *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 156 (1978), *quoting Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

[39] *Edgar v. MITE Corp.*, 457 U.S. 624, 635 (1982), finding that state law frustrated the provisions of the federal Williams Act because it created consequences that Congress in the Williams Act sought to avoid. Similarly, in *Jones v. Rath Packing Co.*, 430 U.S. 519, 540-541 (1977), the Court determined that the federal statute, the Fair Packaging and Labeling Act (FPLA), preempted a California law regulating the labeling by weight of packaged foods, even though the FPLA did not specifically prohibit the state law. This was because the state law would frustrate a major purpose of the FPLA, "to facilitate value comparisons among similar products."

[40] 430 U.S. 274, 279 (1977).

[41] 138 S. Ct. at 2085.

[42] *Id.* at 2087, quoting *Polar Tankers Inc. v. City of Valdez*, 557 U.S. 1, 11 (2009).

[43] *Id.* at 2098.

[44] There are at least seven states (Alabama, California, Colorado, Connecticut, Michigan, New York, and Tennessee) that provide that mere sales alone are sufficient to require the payment of the state's income tax. Similarly, Nevada, Ohio, Tennessee, Texas, and Washington require the payment of the state's gross receipts tax based on sales alone.

otherwise have nexus with the taxing state — whether nexus was established under the physical presence standard of *Quill* or, now, the economic presence standard of *Wayfair*. P.L. 86-272 does not bar a state from taxing the income of an out-of-state company derived from interstate commerce because the tax violates the dormant commerce clause — the state is barred from taxing the out-of-state company's income because Congress passed a federal law prohibiting the state from doing so, and the federal law preempts the state law on the basis of the Constitution's supremacy clause.[45] The fundamental distinction between the dormant commerce clause and the supremacy clause guides the analysis. For the P.L. 86-272 determination, the intent of Congress is paramount. In turn, Congress's understanding of the statutory limit of "the only business activities within such State" is what counts. That the *Wayfair* Court in 2018 found that "a company with a website accessible in South Dakota may be said to have a physical presence in the state via the customers' computers" by leaving "cookies saved to the customers' hard drives, or customers may download the company's app onto their phones"[46] is not relevant to what constitutes "activities within such State" as used in P.L. 86-272. Despite the deference to be accorded to Supreme Court opinions, using dictum from opinions for an unrelated issue cannot have any persuasive effect.[47] In 1959 Congress made clear that activities within the state constituted the type of "feet on the pavement" found in cases such as *Northwestern States Portland Cement Co.* and *Brown-Forman*, which preceded and led to the adoption of P.L. 86-272.[48] Certainly, in 1959, when P.L. 86-272 was adopted, Congress could not possibly have contemplated that in-state activity would be in the nature of cookies, unless it was the Girl Scout kind.

The *Wayfair* Tests Under the Commerce Clause

As discussed, the Court in *Wayfair* confirmed that the constitutionality of a state tax must be determined under the *Complete Auto* four-part test, but changed the requirements for substantial nexus from a physical presence to an economic presence. One reason the Court gave for its rejection of the physical presence standard is that "[t]he physical presence rule is a poor proxy for *the compliance costs faced by companies that do business in multiple States*."[49] According to the Court, "[o]ther aspects of the Court's doctrine can better and more accurately address any potential burdens on interstate commerce, whether or not *Quill*'s physical presence rule is satisfied."[50] Based on the foregoing statement as well as other statements in the Court's opinion, we believe that the Court has added a new and additional test to that of *Complete Auto* to measure the constitutionality of a state tax. That test is whether the state tax places an "undue burden" on interstate commerce.

The Court noted at the start of its opinion the core commerce clause principles:

> Modern precedents rest upon two primary principles that mark the boundaries of a State's authority to regulate interstate commerce. First, state regulations may not discriminate against interstate commerce; and

[45] It is true that P.L. 86-272 was enacted by Congress as an affirmative exercise of its authority under the commerce clause. Once enacted, however, the supremacy clause is the constitutional provision that establishes P.L. 86-272's primacy over conflicting state tax law that would otherwise apply. The line of commerce clause cases culminating in *Wayfair* addressed the constitutional standard under the dormant commerce clause, which has long provided that state laws commerce may be unconstitutional even in the absence of conflicting federal legislation, if they impermissibly burden interstate commerce.

[46] 138 S. Ct. at 2095.

[47] *See, e.g.*, *Arkansas Game and Fish Commission v. United States*, 568 U.S. 23, 35 (2014) (denying precedential effect to "a single sentence unnecessary to the decision," and quoting Chief Justice John Marshall's observation that "general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit when the very point is presented for decision." *Cohens v. Virginia*, 6 Wheat. 264, 399, 5 L. Ed. 257 (1821)).

[48] Based solely on the opinion in *Wayfair*, Cram states that "virtual interaction between the provider and customer in a cloud computing transaction logically establishes in-state business activity." Cram, *supra* note 12. The logical import of what Cram argues is that if a company that sells products sends a confirmatory email to its customers of the date of shipment of the product ordered or an email that there is a delay in shipment, it has engaged in activity within the state of the customer that exceeds solicitation and is not entitled to the immunity from state tax afforded by P.L. 86-272, even though its business is conducted wholly interstate. P.L. 86-272 would be turned into a statute with zero effect under this analysis, and the clear purpose of Congress in enacting the statute to protect interstate commerce will be thwarted.

[49] 138 S. Ct. at 2093 (emphasis added).

[50] *Id.*

> second, *States may not impose undue burdens on interstate commerce*.[51]

The bar to discrimination against interstate commerce is the third prong of the *Complete Auto* test. What is new, however, is the specific prohibition on a state's imposing an undue burden on interstate commerce. Thus, the Court underscored that "other aspects of the Court's commerce clause doctrine can protect against any undue burden on interstate commerce."[52] Without identifying the test for undue burden,[53] the Court pointed to features of the South Dakota law that are designed to prevent undue burden in the context of whether there is "some other principle in the Court's commerce clause doctrine" that might invalidate the South Dakota statute at issue in the case.[54] These features, which some have called the *Wayfair* factors, are as follows:

> First, the Act applies a safe harbor to those who transact only limited business in South Dakota. Second, the Act insures that no obligation to remit the sales tax may be applied retroactively. S.D. 106, § 5. Third, South Dakota is one of more than 20 states that have adopted the Streamlined Sales & Use Tax Agreement. This system standardizes taxes to reduce administrative and compliance costs: it requires a single, state-level tax administration, uniform definitions of products and services, simplified tax rate structures, and other uniform rules. It also provides sellers access to sales tax administration software paid for by the state. Sellers who choose to use such software are immune from tax.[55]

In short, after *Wayfair*, a taxpayer should be able to argue that the tax does not satisfy one or more of the four parts to the *Complete Auto* test or that the tax places an undue burden on interstate commerce. We analyze in the following section the sales tax and income tax obligations of service providers based on the requirements of substantial nexus; and the prohibition of undue burden.

Analysis of Commerce Clause

The starting point to analyze a state's imposition of the sales tax and income tax liability on a services provider is the Court's statement in *Wayfair* that "[t]he Commerce Clause jurisprudence has 'eschewed formalism for a sensitive, case-by-case analysis of purposes and effects.'"[56] To illustrate the analysis that should be made under the *Wayfair* tests, we pose three fact situations, which we have encountered for our clients, and discuss the application of *Wayfair* to each.

In fact situation 1, the company provides SaaS from a server in the cloud, and users access the software by means either of an application programming interface (API)[57] or software provided free of charge to the user. In fact situation 2, the service provider provides storage in the cloud, which is accessed by the customer through an API connection. In fact situation 3, the service provider repairs and patches its customers' software, which in turn is stored on a server in a state other than where the service provider is located or where the customers are located.

In each of these situations the state seeks to require the service provider to collect the sales tax on taxable sales into the state and pay the state's income tax, but the service provider is not located

[51] *Id.* at 2090-2091 (emphasis added).

[52] *Id.* at 2098.

[53] The Court did refer to the solicitor general's argument that tax collection requirements should be analyzed under the balancing framework of *Pike v. Bruce Church Inc.*, 397 U.S. 137 (1970), but the Court did not adopt the *Pike* test. Indeed, no U.S. Supreme Court decision has employed *Pike* to determine the constitutionality of a state tax; *Pike* has been used only in the context of determining whether a state regulation violates the commerce clause. *See*, e.g. *United Haulers Association Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. 330, 346 (2007) (noting that that Pike balancing test "is reserved for laws 'directed to legitimate local concerns, with effects upon interstate commerce that are only incidental.'" (citing *Philadelphia v. New Jersey*, 37 U.S. 617, 624 (1978). *See also C & A Carbone Inc. v. Town of Clarkstown, N.Y.*, 511 U.S. 383, 393 (1994) ("By itself, of course, revenue generation is not a local interest that can justify discrimination against interstate commerce.").

[54] 138 S. Ct. at 2099.

[55] *Id.*

[56] *Id.* at 2094, *quoting West Lynn Creamery Inc. v. Healy*, 512 U.S. 186, 201 (1994).

[57] An API is a set of routines, protocols, and tools by which the service provider defines the key components of a request for SaaS through which users, who employ a third-party software program (not licensed by the service provider to the user), transmit requests into the service provider's system.

in the state. Nor is the server that houses the software for fact situations 1 and 3 or that provides the data storage in fact situation 2 located in the state. The only connection to the state is that customers may be headquartered there or persons (authorized users of the customers) access the service from the state.

Substantial Nexus

Unlike a seller of tangible personal property, a provider of services may not have an economic connection, or at least not the same type of economic connection, to a state. Are the mere facts that users may be located in the state or that customers are billed there sufficient to establish nexus? We believe that a good argument can be made that these contacts in each of the three situations do not create substantial nexus with the state under the economic presence test of *Wayfair*.

The service providers in all three of our fact situations do not "deliver more than $100,000 of goods or services into [the state] or engage in 200 or more separate transactions for the delivery of goods and services into the State," the very basis cited by the Supreme Court in *Wayfair* for the conclusion that "[t]his quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."[58] Indeed, the Court's test ("avails itself of the substantial privilege of carrying on business" in the state) came directly from *Polar Tankers Inc. v. City of Valdez*,[59] in which the taxpayer's oil tankers carrying millions of barrels of oil worth well over $1 million into the city's port created substantial nexus with the city. Similarly, the *Polar Tankers* test was derived from *Japan Line Ltd. v. County of Los Angeles*,[60] in which the taxpayer's vessels made frequent deliveries of containers to the California ports that sought to assess a tax on the taxpayer.

As additional support for the argument that a service provider does not have nexus based merely on users accessing its cloud services, or the software that it services, we note that the Supreme Court's finding of substantial nexus was "based on *both the economic and virtual* contacts respondents have with the State."[61] None of the service providers in the fact situations we outlined use any state-funded infrastructure, such as the roads and highways or even the telephone system, to deliver their services. It is the customer who uses the state infrastructure to access the company's services.

Perhaps the strongest substantial nexus arguments would apply to situations 2 and 3. In situation 2, the service provider does not deliver the service to the customer in the taxing state; it merely stores data for the customer on a server not located in the taxing state. Similarly, in situation 3, the service provider has no connection to the state where the user accesses the software that the service provider repaired. Absent some other connection by the service provider to the state, the state would be hard-pressed to argue that the provider's services are delivered to persons in the state. Even in situation 1, while there is a link between the service provider and the user located in the state, the service provider is not "carrying on business in the State," inasmuch as there are few benefits afforded by the state to require the service provider to bear a portion "of the burden of tax collection."[62] The receipt of benefits from a state, and using the tax money to be collected by the company to fund those benefits, was a linchpin of the *Wayfair* Court's analysis.[63]

We submit that the mere billing of the customer in the state does not establish the substantial connection. If, however, the service provider travels to the state to conclude a contract with one or more customers, or to provide services to the customers, then arguably the service provider has substantial nexus with the state.

It is a closer question if the service provider maintains a website to display the services it offers and receives orders at the website from customers in the state. The Supreme Court did refer to the seller's maintaining a "virtual

[58] 138 S. Ct. at 2099.

[59] 557 U.S. 1, 11 (2009).

[60] 441 U.S. 434, 441-445 (1979).

[61] 138 S. Ct. at 2099 (emphasis added).

[62] *Id.*at 2096.

[63] *Id.* at 2096 ("But there is nothing unfair about requiring companies that avail themselves of the States' benefits to bear an equal share of the burden of tax collection.").

showroom" as providing for "greater opportunities for consumer and seller interaction than might be possible for local stores."[64] But the open question from the Court's opinion is whether mere virtual contacts, without the economic contacts of delivery of products or services into the state, are sufficient to establish substantial nexus. In today's world, where virtually every business maintains a website, basing substantial nexus solely on the virtual contacts of an internet presence would dilute the substantial nexus prong of *Complete Auto* to a meaningless requirement.

Undue Burden

As described above, the *Wayfair* Court did note that there are "compliance costs faced by companies that do business in multiple States," but stated that "[o]ther aspects of the Court's doctrine can better and more accurately address" such costs.[65] Service providers face additional burdens that sellers of tangible personal property encounter in complying with the tax laws of multiple states when they do business in interstate commerce.

The Court pointed out that one feature of the South Dakota law that reduced this burden to internet sellers are uniform rules among the Streamlined Sales and Use Tax Agreement states.[66] In general, the sourcing rules for the sale of tangible personal property are uniform; the sale is sourced to the state of destination, except for a few states that have origin sourcing under limited circumstances. But that is not the case for sourcing of services, in which there are five bases among the states for sourcing services, namely the state where (1) the service is performed; (2) the service is delivered (for software repair where the service is located); (3) the benefit of the service is received (for example, if it is repair of software used to generate financial statements the benefit is likely to be where the administration or headquarters of the state of the customer is); (4) the users of the software are located; or (5) the customer's bill is sent or as set forth on the provider's records.[67] Thus, under this mosaic of sourcing of services, more than one state can source the same service to its state. It is our position that this is an added burden of tax collection for a provider of services that, together with other arguments, could form a basis to defeat the imposition of a tax collection obligation on the provider.

Sourcing of services for sales tax purposes may also constitute discrimination against interstate commerce, inasmuch as an interstate service provider may be subject to taxation in two or more jurisdictions for the same service. For example, for data storage, the provider could be responsible for sales tax not only where the data is stored but also in the states where the customer is billed, as well as the states from which the users access the data. A provider of data storage services to a company located in the same state need contend with only one state's laws.

Insofar as income tax, there is no uniformity among the states for sourcing of sales for apportionment of a multistate company's income. There are at least four locations for sourcing among the states, such as the places of performance, delivery, and benefit as well as the location where receipts are derived.[68] Of course, different formulas for apportionment of income among the states does not violate *Complete Auto*.[69] Whether the different methods of sourcing sales will pass muster post-*Wayfair* remains to be seen.

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[64] *Id.* at 2095.

[65] *Id.* at 2085, 2093.

[66] *Id.* at 2100.

[67] *See* Shirley Sicilian, Raj Lapsiwala, and Sarah Vergel De Dios, "After Wayfair, A Focus on Sourcing," *J. of Multistate Taxation and Incentives*, 39 (Oct. 2018) (noting the different bases for sourcing of digital goods for sales tax purposes).

[68] *Id.* and Douglas A. Wick, "A Categorization of State Market Sourcing Rules," *State Tax Notes*, Nov. 10, 2014, p. 351.

[69] *See Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175, 195 (1995). ("We have never required that any particular apportionment formula or method be used, and when a State has chosen one, an objecting taxpayer has the burden to demonstrate by 'clear and cogent evidence' that 'the income attributed to the State is in fact out of all appropriate proportions to the business transacted . . . in that State, or has led to a grossly distorted result.'" (citing *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 170 (1983))).

Analysis of Due Process Clause

The due process clause standard of nexus is similar but not identical or coterminous with that of the commerce clause substantial nexus standard, as set forth in *Wayfair*.[70] It is difficult to determine how the two clauses differ, especially since the Court's substantial nexus test under the commerce clause is derived from *Polar Tankers*, which was based, in part, on the due process analysis in *Quill* and the Supreme Court's opinion in *Mobil Oil Corp. v. Commissioner*,[71] which determined whether a state income tax violated the due process clause.

We submit that the difference in the nexus tests under the two constitutional provisions relates to the knowledge of the seller of the destination of its goods or services and includes the seller's efforts to market to the state. Thus, the Court in *Wayfair* quoted the due process standard set forth in *Miller Brothers*[72] that there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[73] In *Miller Brothers*, the Court invalidated under the due process clause a Maryland use tax assessed against a Delaware retailer for sales made from its store to Maryland residents, because the retailer had no knowledge of where its customers would use the goods. Similarly, in an opinion written by Justice Anthony M. Kennedy, *J. McIntyre Machinery Ltd. v. Nicastro*,[74] the Court held that an out-of-state company was not subject to the personal jurisdiction of the New Jersey courts because it had not engaged in conduct "purposefully directed at New Jersey." What was critical to the Court was that there was no evidence that the company "purposefully availed itself of the New Jersey market."[75]

In short, it is our position that to give substance to the Supreme Court's statement in *Wayfair* that the commerce clause and due process clause nexus tests are not identical, the due process clause requires some intentional and knowing direction of activities to a state to permit the state to impose sales tax and income tax obligations on an out-of-state company. For each of the three fact situations outlined above, we submit that the due process nexus standard would not be satisfied in the state based solely on the performance and delivery of the service by the service provider. The real question is whether if the service provider were to market its services through a website, would it be deemed to have nexus. We think not. While a website would be accessible in the state, it is also accessible throughout the world. The service provider is not purposefully directing marketing to the state.

Conclusion

The Supreme Court's decision in *Wayfair* has certainly caused a major change in commerce clause analysis. A provider of services (like a seller of tangible personal property) can no longer rely on the bright-line rule that because it does not have a physical presence in a state it is not subject to the state's sales tax or other taxes based on *Quill*. Nevertheless, the service provider has an additional argument of undue burden, the scope of which will still need to be determined. Also, we submit that a provider of services may continue to argue that it is protected from a foreign state's income tax under P.L. 86-272, so long as it does not engage in activities exceeding protected solicitation. *Wayfair* did not change the test. *Wayfair* also clarifies that the due process nexus standard provides an additional basis for challenge by a service provider to imposition of sales tax and other state tax liability. ■

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[70] 138 S. Ct. at 2093.

[71] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 437 (1980).

[72] *Miller Brothers Co. v. Maryland*, 347 U.S. 340-345 (1954).

[73] 138 S. Ct. at 2093.

[74] 564 U.S. 873, 886 (2011).

[75] *Id.*