What to Do With Public Law 86-272

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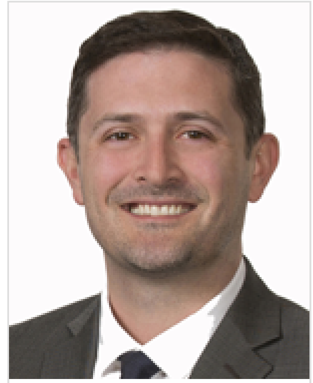
In this inaugural installment of Internally Consistent, Lutz discusses how states and Congress should address challenges presented by Public Law 86-272 and criticizes state efforts to interpret the law out of existence.



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In the past 15 years, the state corporate income tax landscape has undergone significant change. Although the tax makes up a small percentage of overall state and local tax revenue,[1] states and businesses spend an inordinate amount of time arguing over it. States, meanwhile, have aggressively exported their tax base to out-of-state businesses by dramatically shifting to a single-sales-factor apportionment method. More than half of the states with a corporate income tax have now adopted market-based sourcing. And they continue to adopt mandatory unitary combined reporting.

But one thing that has not changed is Public Law 86-272.[2] Adopted in 1959 — and unamended since — P.L. 86-272 was meant as a stopgap to address the U.S. Supreme Court decision in *Northwestern States Portland Cement Co. v. Minnesota*.[3] The law provides that no state or political subdivision thereof shall have the power to impose a net income tax on income derived within the state by any person from interstate commerce if their business activities in the state during the tax year are limited to solicitation of orders of tangible personal property that are sent outside the state for approval and, if approved, are filled by shipment or delivery from a point outside the state. The legislation provides protections for activities conducted by independent contractors for out-of-state sellers.

Ultimately, there are six important components to the law: (1) sales must be made in interstate commerce; (2) the tax at issue must be based on net income; (3) only sellers of tangible personal property are covered; and (4) activities in the state must be limited to solicitation and (5) shipment or delivery (6) where such delivery initiates outside the state. So out-of-state sellers of tangible personal property may conduct two activities in a state while retaining P.L. 86-272 protection: solicitation and delivery. The seminal case regarding P.L. 86-272, *Wisconsin Department of Revenue v. William Wrigley Jr. Co*.,[4] helped shed light on the permissible extent of these activities. Importantly, activities ancillary to solicitation remain protected even if those activities viewed alone would not otherwise be protected. The Court explained that "whether a particular activity is a *de minimis* deviation from a prescribed standard must, of course, be determined with reference to the purpose of the standard. . . . Accordingly, whether in-state activity other than 'solicitation of orders' is sufficiently *de minimis* to avoid loss of the tax immunity conferred by section 381 depends upon whether that activity establishes a nontrivial additional connection with the taxing State."[5]

The Problem

Here's the problem: Nobody today likes the lines Congress drew in 1959. From my vantage point, Congress intended to protect most interstate sellers from being subject to state income taxation in states where those sellers conducted no activities other than accessing the market. Sales of services in 1959 generally did not cross state lines in the way they do today. Even if they did, states did not apportion the sale of services or intangibles according to the market; they uniformly used some form of income-producing activity test. Digital services and products were certainly not on Congress's radar. After these changes to the economy and state apportionment rules, the purpose of P.L. 86-272 is barely being served. And to the extent P.L. 86-272 still acts as a meaningful barrier to states' abilities to impose a net income tax, the Multistate Tax Commission appears poised to sap any remaining force the law might have.[6]

In a recent article in this publication, Roxanne Bland contended that Congress's recent efforts with the Business Activity Tax Simplification Act and its "wholesale rewriting of P.L. 86-272 would essentially relegate states to taxing business income the way it was done in the 1950s, when America had a manufacturing economy." This, Bland contends, "would also create substantial amounts of 'nowhere income.'"[7] The MTC generally appears to agree with this concern as it looks to update its policy statement regarding P.L. 86-272. Michael Fatale, deputy general counsel for the

Massachusetts Department of Revenue, who has argued since at least 2002 that P.L. 86-272 violates the U.S. Constitution,[8] appears to be a vocal figure in the MTC's effort to subvert the statute's protections by pointing to internet or other digital contacts that sellers of tangible personal property may have with a state.[9]

The MTC Uniformity Committee began its P.L. 86-272 project November 7, 2018. Brian Hamer, counsel for the MTC, has said that the project is limited to considering the application of P.L. 86-272 to modern business activities. While that scope of review sounds limited, Hamer's April 25 status report indicates that the MTC intends to address whether using an interactive website to sell property into a state exceeds P.L. 86-272 protections.[10]

I'm not so sure the MTC's Uniformity Committee is really geared to faithfully construe the text and purpose of P.L. 86-272, just as I am skeptical that P.L. 86-272 may provide protection for digital service providers, as some practitioners have argued.[11] What I think we're really left with are two perspectives that agree on one central premise: P.L. 86-272 is outdated and should either be updated to address the concerns Congress hoped to resolve after *Northwestern States* or be repealed.

The economy in 2019 is different from 60 years ago in at least three major respects: It is service-based and digital, global, and simply more efficient from a logistical perspective. We need to review how these changes affect interstate income tax obligations to reach a reasonable conclusion regarding the desired fate of P.L. 86-272.

Services and the Digital Economy

The MTC's Uniformity Committee is focused on the digitalization of interstate commerce, and much of its thinking appears to be influenced by *Wayfair.*[12] As Amy Hamilton reported on the April 25 meeting, Fatale and the P.L. 86-272 MTC work group participants often quote the following passage from *Wayfair*:

> Between targeted advertising and instant access to most consumers via any internet-enabled device, "a business may be present in a State in a meaningful way without" that presence "being physical in the traditional sense of the term." . . . A virtual showroom can show far more inventory, in far more detail, and with greater opportunities for consumer and seller interaction than might be possible for local stores. Yet the continuous and pervasive virtual presence of

retailers today is, under *Quill*, simply irrelevant. This Court should not maintain a rule that ignores these substantial virtual connections to the State.

While references to *Wayfair* confuse me (P.L. 86-272 protection presupposes nexus exists), the MTC is ultimately asking whether providing the ability to access an interactive website might exceed the protected activities of P.L. 86-272. The MTC appears particularly interested in the role that internet cookies play in all this. Do these lines of code in your web browser that track internet activity to advertise particular items or modify your website experience to optimize the time you spend on the site exceed solicitation in the state?[13]

In my view, if the product being sold is tangible personal property, whether a salesperson or a website is soliciting sales in the state should be irrelevant. There's a strong argument that an actual person in the state can be far more dynamic than a website, however sophisticated. And it appears that these websites are entirely geared toward solicitation of sales; any activities that may be construed otherwise would be ancillary and fall well within the boundaries set in *Wrigley*. But even if this view can be contradicted, I think there is little debate that this exception would swallow the rule. Given Congress's swift action after *Northwestern States*, I can't imagine Congress intended the protections in P.L. 86-272 to be interpreted out of existence.

Foreign Commerce

It's also a product of history that P.L. 86-272 does not protect all sellers of tangible personal property outside a state — only interstate commerce is protected. I think the purposes of this were at least twofold. First, the facts in *Northwestern States* did not involve a foreign seller, and P.L. 86-272 was meant as a direct response to that decision. Second, foreign sellers were a much rarer occurrence in 1959 than today. P.L. 86-272 protection for foreign sellers has generally not been a sticking point for states.[14] Illinois, Michigan, Montana, and Utah, for instance, have specifically extended P.L. 86-272 protections to foreign commerce.[15] While some practitioners have suggested that refusing to extend P.L. 86-272 protections to foreign commerce may violate the foreign commerce clause, I am somewhat skeptical.[16] It is not the states providing preferential treatment to interstate businesses as opposed to foreign businesses; it is Congress. And it is probably Congress's prerogative to do so.

There are, however, at least two arguments in favor of foreign entities receiving P.L. 86-272 protections. First, once property enters the United States and is transported across state lines, the transaction can be said to be both foreign and interstate in nature. In that case, the protections of

P.L. 86-272 would apply. Also, states such as Florida apply the standards of P.L. 86-272 to sellers making sales to international customers to determine whether those sellers are subject to tax in the destination country.[17] To the extent a state uses this standard to determine whether a taxpayer is subject to tax in a foreign destination, it should be held to that same standard for determining its own jurisdictional reach.[18]

Regardless of the legal arguments surrounding the applicability of P.L. 86-272 to foreign commerce, the problems with the law again become apparent. To the extent P.L. 86-272 creates a dynamic in which states are more likely to impose a corporate income tax on a foreign seller (who may even be treaty protected from a federal standpoint) as opposed to an interstate seller, it can only be understood to reach an absurd result.

What Constitutes 'Delivery,' Anyway?

Finally, I cannot speak to the logistics companies used in the 1950s, but it is rare today for a company that uses its own trucks to deliver products into a state to not also backhaul out of that state. Otherwise, 50 percent of that truck's trip is effectively worthless. As recently as December 2018, the California Franchise Tax Board emphasized that delivery via a private delivery truck is protected by P.L. 86-272, but any activity beyond delivery, such as backhauling, is not.[19] Practically speaking, backhauling is an essential part of delivery. Still, there are separate economic incentives to do so. Could backhauling be considered ancillary to delivery? The answer may depend on the nature of what is backhauled; backhauling returned goods may receive different analysis from backhauling scrap metal unrelated to the seller's sales of tangible personal property into the state. Again, P.L. 86-272 does not anticipate or address this dynamic despite its ubiquity.

What to Do, What to Do?

The states' concerns regarding pending legislation that would expand P.L. 86-272 are overstated for two simple reasons: throwback and throwout. Approximately 23 states have adopted some form of throwback and at least three other states use a throwout rule for sales of tangible personal property. Bland's contention that a revamped P.L. 86-272 would create substantial amounts of "nowhere income" makes no reference to throwout or throwback. And while I may have qualms with the way the throwout rule is applied to services and the sale or license of intangibles today (it seems fundamentally inconsistent with economic nexus and market-based sourcing), throwback is at its best when used to capture nowhere income created by P.L. 86-272.

So states' attempts to shrink the protections of P.L. 86-272 would not necessarily result in more income taxes being paid. Instead, these efforts simply shift where the income of a taxpayer would be subject to tax. And that is frustrating because while state revenues will not increase in any meaningful way, costs of compliance and risks of audit will increase dramatically. This is not like use tax in which the tax is exclusively destination based and sellers may avoid all tax responsibility.[20] Balancing the interests of taxpayers and states, I see little benefit to the states in undermining P.L. 86-272 and I see substantial costs to taxpayers. This would be true even if P.L. 86-272 were extended to services and the digital economy.

As states and Congress contemplate how P.L. 86-272 should function in the 21st century, they would do well to consider the differences between use tax and income tax. Income taxation of multistate businesses is often a zero-sum game; the only variable is the cost and risk associated with compliance on a multistate basis. An honest conversation regarding the role P.L. 86-272 should play in interstate commerce comes down to one basic question: Should P.L. 86-272 stay or go? I say it should stay. In order to do that, the law needs to be updated to reflect economic reality in 2019. And if you think it should go, the SALT community deserves a cogent explanation as to why, not a concentrated effort to interpret the law out of existence.

FOOTNOTES

[1] According to the Council on State Taxation and EY's November 2018 study, "Total State and Local Business Taxes," corporate income taxes made up 8.5 percent of business's total state and local tax obligations for 2017.

[2] 15 U.S.C. section 381.

[3] 358 U.S. section 450 (1959).

[4] 505 U.S. section 214 (1992).

[5] *Id*. at 232.

[6] On the MTC's public notice and agenda for its August 20, 2019, meeting of the P.L. 86-272 Statement of Information Work Group, the first reference material is Darien Shanske, "State Tax Administrators: Please Do Your Part in Sending P.L. 86-272 off Into the Sunset," Medium, July 5, 2019. This article asserts that *Wayfair* sets an adequate nexus standard for income tax nexus, the MTC "is clearly on the right track," and Shanske hopes "it publishes clear guidance to the states

about how they ought to fairly — and narrowly — interpret P.L. 86-272" — in other words, interpreting P.L. 86-272 out of existence.

[7] Roxanne Bland, "Business Activity Tax Simplification Act: It's Ba-A-Ack!" *Tax Notes State*, July 8, 2019, p. 129. The current iteration of the Business Activity Tax Simplification Act extends P.L. 86-272 protection to services, digital goods, and digital services, among other changes. H.R. 6978, 115th Cong. (2017-2018).

[8] Michael Fatale, "Federalism and State Business Activity Tax Nexus; Revisiting Public Law 86-272," 21 *Va. Tax. Rev.* 435 (2002).

[9] Amy Hamilton, "Inside the Talks on Activities Exceeding P.L. 86-272 Protection," *State Tax Notes*, Apr. 29, 2019, p. 447 ("'That's the way the business works,' Fatale said. 'Yeah, the software's everywhere. So be it. If it means the 86-272 protection is blown, it's blown. There's no entitlement to a 1959 protection for, like, forever.'").

[10] Brian Hamer, "Report to the Uniformity Committee, Status of P.L. 86-272 Statement of Information Project," MTC (Apr. 25, 2019).

[11] *See* Martin Eisenstein and Nathaniel A. Bessey, "Public Law 86-272: Sunlight for a Cloud Service," *State Tax Notes*, May 21, 2018, p. 769. For a rebuttal, see Richard Cram, "No Shade for Cloud Computing Income Under P.L. 86-272," *State Tax Notes*, Sept. 24, 2018, p. 1237.

[12] *South Dakota v. Wayfair Inc.*, 585 U.S. ___ (2018).

[13] There has been some debate in the regular Uniformity Committee calls about whether cookies are software. I'm not sure that matters. What really matters is what the cookies do. Hamer's report provides several links explaining how cookies function. I am going with the definition provided by the Federal Trade Commission on its website: "A cookie is information saved by your web browser, the software program you use to visit the web. When you visit a website, the site might store a cookie so it can recognize your device in the future. Later if you return to that site, it can read that cookie to remember you from your last visit. By keeping track of you over time, cookies can be used to customize your browsing experience, or to deliver ads targeted to you."

[14] *But see* California Franchise Tax Board Informational Publication No. 1050 (June 1, 2017) (stating P.L. 86-272 protection only applies to the United States and Puerto Rico); and New Mexico Taxation

and Revenue Department, "Corporate Income Tax Audit Manual" (May 1, 2007) ("P.L. 86-272 only applies to interstate commerce and not to foreign commerce.").

[15] 86 Ill. Admin. Code 100.9720(c)(8); Michigan Rev. Admin. Bull. 2014-5 (Jan. 29, 2014); Mont. Admin. R. 42.26.508; and Utah Admin. R. R865-6F-6(14).

[16] *See* Andrea Muse, "P.L. 86-272 Protections Might Apply to Foreign Companies," *State Tax Notes*, Mar. 18, 2019, p. 1013.

[17] Fla. Admin. Code Ann. 12C-1.015(1)(b)(8).

[18] This logic effectively becomes a "reverse *Lorillard*" approach, when the New Jersey Tax Court held that a state must apply its own nexus rules to determine whether a taxpayer is subject to tax in another jurisdiction for purposes of the throwout rule. *Lorillard Tobacco Co. v. Director*, *Division of Taxation*, No. 008305-2007 (N.J.T.C. 2019).

[19] FTB, Technical Advice Memorandum 2018-03 (Dec. 4, 2018).

[20] Ironically, after *Wayfair*, taxpayers may have a better argument that state expansion of income tax jurisdiction is more constitutionally suspect than states' expansion of their jurisdiction to require use tax collection. In *Pike v. Bruce Church Inc.*, the Supreme Court explained that when a state law affecting interstate commerce "regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits. If a legitimate local purpose is found, then the question becomes one of degree. And the extent of the burden that will be tolerated will, of course, depend on the nature of the local interest involved, and on whether it could be promoted as well with a lesser impact on interstate activities." 397 U.S. 137, 142 (1970). Considering the throwback rule, it appears that states have less of an interest in expanding their income tax jurisdictional reach than their sales and use tax jurisdictional reach.

END FOOTNOTES

DOCUMENT ATTRIBUTES

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