No Shade for Cloud Computing Income Under P.L. 86-272

by Richard L. Cram

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In this viewpoint, Cram responds to a recent *State Tax Notes* article by Martin Eisenstein and Nathaniel Bessey, arguing that Public Law 86-272 implicitly preempts states' ability to impose net income tax on a cloud computing service provider's income if the provider has no in-state business activities. Cram writes that the federal statute contains no implicit preemption and is unlikely to protect cloud computing service providers' income.

In their recent article concerning federal constraints on state taxation of cloud computing income, Martin I. Eisenstein and Nathaniel A. Bessey[1] contend that Public Law 86-272,[2] the Interstate Income Tax Act of 1959, implicitly preempts a state from taxing an out-of-state company's net income from selling cloud computing services, unless that company has conducted some in-state activity. The authors claim that this implicit preemption protects a cloud computing service provider's income from state taxation when the provider has only customers in the taxing state and otherwise conducts no business activities there — regardless of whether the product provided is considered tangible personal property or a service. They include software as a service (SaaS), infrastructure as a service (IaaS), remote networks, desktop monitoring, and help desk services in their definition of cloud computing.[3]

Cloud computing essentially involves providing the customer with remote access to computer software, hardware, or both. The language of P.L. 86-272, its legislative history, and court decisions construing it do not support the authors' contention. P.L. 86-272 protects an out-of-state seller from a state or local net income tax when the seller's activities are limited to in-state solicitation of orders for the sale of tangible personal property if the orders are sent out-of-state for acceptance and delivery of the items occurs from a point outside the state.[4] P.L. 86-272 has no apparent application to cloud computing.

Eisenstein and Bessey wrote their article while *South Dakota v. Wayfair Inc.*[5] was pending, but they nonetheless claimed their implicit preemption argument stands, regardless of the outcome in that case.[6] *Wayfair* has been decided. The U.S. Supreme Court, in reviewing South

[1] Eisensten and Bessey, "Public Law 86-272: Sunlight for a Cloud Service," *State Tax Notes*, May 21, 2018, p. 769.

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

[3] *Supra* note 1, at 770.

[4] 15 U.S.C. section 381(a)(1). "Missionary sales" or independent contractor solicitation activities, addressed in 15 U.S.C. section 381(a)(2) and (c), are beyond the scope of this article.

[5] 138 S. Ct. 2080 (2018).

[6] *Supra* note 1, at 770 ("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.").

Dakota's economic nexus statute, S.B. 106, overruled *Quill*[7] and *National Bellas Hess*,[8] disposed of the physical presence nexus standard for requiring remote sellers to collect use tax, and determined that substantial nexus under the commerce clause existed as to the internet retailer respondents.[9] The Court remanded the case to the South Dakota Supreme Court to determine the statute's constitutionality. The Court acknowledged that an internet seller's "economic and virtual contacts" in the market state may be considered in determining whether the substantial nexus prong of the four-part *Complete Auto*[10] commerce clause test is satisfied.[11]

Although *Wayfair* dispensed with the *Quill* physical presence nexus requirement for imposing a use tax collection duty on an out-of-state seller, that decision also applies to income tax nexus analysis.[12] Before *Wayfair*, with rare exception,[13] state courts consistently held that the now-overruled *Quill* physical presence requirement did not apply to income tax nexus.[14] The Court has repeatedly denied review of that issue.[15] *Wayfair* permits a determination of substantial nexus regarding a cloud computing service provider when the provider derives net income from customers — regardless of the provider's physical presence in the market state.

The first section of this article reviews the background and language of P.L. 86-272 to show that its preemption is narrowly limited to state taxation of income from sales of tangible personal property under some circumstances. The second section reviews the legislative history of P.L. 86-272 and interpretive court decisions, showing the lack of any implicit preemption of state taxing authority. The third section explains that the P.L. 86-272 elements needed to protect cloud computing income from taxation are unlikely to be present. The fourth section discusses *Wayfair*'s impact on income tax nexus analysis applicable to cloud computing income: physical presence in the market state is not necessary for substantial nexus.

I. P.L. 86-272 Preemption

Congress enacted P.L. 86-272 as a stopgap measure in reaction to and only a few months after *Northwestern States Portland Cement*.[16] That case upheld Minnesota's imposition of its apportioned net income tax on an out-of-state manufacturer whose operations in the state were limited to sales solicitation (the company had permanent sales staff and an office in the state).[17]

[7] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[8] *National Bellas Hess v. Illinois Department of Revenue*, 386 U.S. 753 (1967).

[9] 138 S. Ct. at 2099. S.B. 106 requires sellers with no physical presence making sales to South Dakota customers exceeding either $100,000 in sales or 200 or more transactions in the prior year to collect and remit its use tax.

[10] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977) (The Court will sustain a tax so long as it applies to an activity with a substantial nexus with the taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services the state provides).

[11] 138 S. Ct. at 2099.

[12] In overruling *Quill* and *National Bellas Hess*, the *Wayfair* Court, without qualification, stated that the physical presence rule was "unsound and incorrect." 138 S. Ct. at 2099. *See* Jaye Calhoun and William J. Kolarik II, "Implications of the Supreme Court's Historic Decision in *Wayfair*," *State Tax Notes*, July 9, 2018, p. 125, at 135; and Paul Jones, "*Wayfair* May Apply More Broadly to Corporate Tax Nexus Dispute," *State Tax Notes*, July 9, 2018, p. 187 (noting that *Wayfair*'s abolishment of the physical presence nexus requirement may apply to all state and local taxing regimes).

[13] *See, e.g., J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. App. 2000).

[14] *Supra* note 1, at 775, nn.30-31. The authors acknowledged state court decisions determining that the *Quill* physical presence nexus standard did not apply for purposes of determining income tax nexus, citing *Tax Commissioner v. MBNA America Bank*, 640 S.E.2d 226, 235 (W.Va. 2006); and *Geoffrey Inc. v. Commissioner of Revenue*, 899 N.E.2d 87, 89 (Mass. 2009). *See also Geoffrey Inc. v. South Carolina*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1994); *A&F Trademark Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *Lanco Inc. v. Director, Division of Taxation*, 908 A.2d 176, 176 (N.J. 2006), *cert. denied*, 551 U.S. 1131 (2007); *MBNA America Bank N.A. v. Indiana Department of State Revenue*, 895 N.E.2d 140, 143 (Ind. Tax Ct. 2008); and *KFC Corp. v. Iowa Department of Revenue*, 792 N.W.2d 309, 322, 328 (Iowa 2010), *cert. denied*, 565 U.S. 817 (2011).

[15] *Id*. *See also* Michael T. Fatale, "The Evolution of Due Process and State Tax Jurisdiction," 55 *Santa Clara L. Rev.* 565, 583-585, n.106 (2015) (discussing South Carolina's *Geoffrey* opinion and additional decisions finding income tax nexus without physical presence, in which the Court denied certiorari).

[16] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

[17] 105 Cong. Rec. H 17774 (Sept. 2, 1959) (Celler remarks).

After that decision, multistate businesses expressed concern about the burden of complying with several states' income tax laws, based solely on their solicitation activities in those states.[18]

P.L. 86-272 provides that no state or political subdivision shall have the power to impose a net income tax on an out-of-state seller deriving income from interstate commerce if the seller's only business activities within the state are:

> the solicitation of orders by such person, or his representative, in such State for sale of tangible personal property, 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.[19]

Under this language, P.L. 86-272 protection applies only when there is in-state solicitation of orders for sales of tangible personal property, assuming the other statutory criteria are met. Eisenstein and Bessey acknowledge that P.L. 86-272 limits the categories of protected activities to solicitation of sales of tangible personal property in a state, but argue that the law "does not limit the categories of income from interstate commerce that are immune from taxation."[20] Thus, they claim, "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."[21] However, nothing in the language of P.L. 86-272 indicates that it preempts state taxation of an out-of-state seller's interstate income derived from the sale of services.[22]

A state may voluntarily apply the P.L. 86-272 preemption to taxation of income from services.[23] Absent such a voluntary application, however, state taxing agencies generally view the P.L. 86-272 preemption as applying only to taxation of income from sales of tangible personal property.[24] Tax scholars and commentators have also long noted that the P.L. 86-272 preemption applies only to taxation of income from sales of tangible personal property — not services. For instance Paul J. Hartman and Charles A. Trost wrote:

> Public Law 86-272 exempts from net income taxation only sales of tangible personal property. It has no application to the activities connected with the sale of services. . . . Presumably, therefore, there would be no tax relief in Public Law 86-272 from an otherwise valid tax on net income of such businesses as trucking companies, taxicabs, pipelines, newspapers, radio and television broadcasting, telephone and telegraph companies, railroad, airline and water transportation, and insurance.[25]

[18] *Id.* at 17772 (Patman remarks). Justice Harry Blackmun explained in his dissent in *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214, 238-240 (1992), that P.L. 86-272 was the legislative response to *Northwestern States Portland Cement* and state court decisions in *International Shoe Co. v. Fontenot*, 107 So.2d 640 (La. 1958), *cert. denied*, 359 U.S. 984 (1959); and *Brown-Forman Distillers Corp. v. Collector of Revenue*, 101 So.2d 70 (La. 1958), *appeal dismissed*, 359 U.S. 28 (1959). *See* Fatale, "Federalism and State Business Activity Tax Nexus: Revisiting Public Law 86-272," *Va. Tax Rev.*, 436, 474-479 (2002).

[19] 15 U.S.C. section 381(a)(1).

[20] *Supra* note 1, at 772.

[21] *Id.*, n.18. The authors cite a footnote in *MBNA Bank*, 640 S.E.2d at 229 n.6 (discussing unsuccessful efforts to amend P.L. 86-272 to expand its preemption to other forms of property and services). Those efforts would have been unnecessary if the P.L. 86-272 preemption applied beyond the taxation of income from sales of tangible personal property.

[22] 15 U.S.C. section 381(a)(1). *See* John A. Swain, "State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective," 45 *Wm. & Mary L. Rev.* 319, 325 (2003) ("P.L. 86-272 . . . says nothing about services or intangibles.").

[23] *See* Virginia Department of Taxation Ruling of Commissioner P.D. 10-252 (Nov. 10, 2010) ("Virginia applies P.L. 86-272 to sales of services and intangibles, although P.L. 86-272 only applies to sales of tangible personal property.").

[24] *See, e.g.*, Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86-272 (revised July 27, 2001). *See also* California Franchise Tax Board, FTB Publication 1050, June 2017 (adopting the MTC statement).

[25] Hartman and Trost, *Federal Limitations on State and Local Taxation 2d*, Vol. 2, sections 10:8, 10:9. *See also* Robert L. Roland, "Public Law 86-272," *Virginia L. Rev.* 1172, 1176 (Oct. 1960).

II. No Implicit Preemption of State Taxing Authority

Under federalism principles, the power to tax is "central to state sovereignty."[26] A court considering federal preemption of state taxing authority assumes no preemption absent a "clear and manifest purpose of Congress."[27] Defining the preemptive reach of a statute implies no preemption beyond that reach.[28] When a federal statute unambiguously forbids states from imposing a particular kind of tax, "courts need not look beyond the plain language of the federal statute to determine whether a state statute that imposes such a tax is pre-empted."[29]

Eisenstein and Bessey contend that congressional intent for implicit preemption in P.L. 86-272 can be "explicitly stated in the statute's language or implicitly contained in its structure and purpose."[30] They also quote language from *Heublein*[31] to the effect that P.L. 86-272 was designed to define a lower limit for the exercise of state taxing power, noting[32] that this same language was quoted in *Wrigley*.[33] They argue that when a company has no in-state business activities, it evidently falls below that "lower limit" and has protection under P.L. 86-272. Thus, the statute somehow implicitly preempts the state's power to tax the company's income regardless of whether that income derives from sales of tangible personal property or services.[34]

There are several problems with this argument. First, as discussed, the plain language in P.L. 86-272 provides only a narrow preemption. The law's explicit preemption language applies only to taxation of income derived from sales of tangible personal property. Second, the legislative history of P.L. 86-272 also shows a lack of congressional intent for any implicit preemption of state taxing authority. Third, neither *Heublein* nor *Wrigley* concerned state taxation of income arising from sales of services. In fact, *Heublein* supports a narrow reading of the P.L. 86-272 preemption. To the extent that P.L. 86-272 established any lower limit of state taxing authority, that limit applies only to state taxation of income arising from sales of tangible personal property. Finally, state courts have not read P.L. 86-272 as containing any implicit preemption.

The legislative history of P.L. 86-272 shows congressional intent for only the narrow preemption. During the summer of 1959, both the House of Representatives and Senate passed separate preemption bills: H.R.J. Res. 450 and S. 2524.[35] The House bill was time-limited to tax years ending after December 31, 1959, and beginning before January 1, 1961, and would have broadly preempted state taxation of not only interstate income from sales of tangible personal property, but also from services and intangibles.[36] S. 2524 had no time limit but contained the much narrower preemption language, applying only to taxation of income from sales of tangible personal property.[37] Describing the provisions of S. 2524, the committee report stated:

> Whether business activities other than those described in the bill constitute a sufficient basis for the imposition by a State or political subdivision thereof of a net income tax on income derived from

[26] *Department of Revenue of Oregon v. ACF Industries Inc.*, 510 U.S. 332, 345 (1994) (no preemption of Oregon property tax exemption for nonrailroad property by the Railroad Revitalization and Regulatory Reform Act of 1976). *See* Fatale, "Common Sense: Implicit Constitutional Limitations on Congressional Preemptions of State Tax," *Mich. St. L. Rev.* 41, 42, n.3 (2012).

[27] *Id.* (citing *Cipollone v. Liggett Group Inc.*, 505 U.S. 504, 516 (1992), quoting *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947)).

[28] *Cipollone*, 505 U.S. at 517.

[29] *Shell Oil Co. v. Iowa Department. of Revenue*, 488 U.S. 19, 25 (1988) (quoting *Aloha Airlines Inc. v. Director of Taxation of Hawaii*, 464 U.S. 7, 12 (1983) (After considering the language, background, and legislative history of the Outer Continental Shelf Lands Act, the Court determined that the statute did not prevent Iowa from requiring Shell to include in Iowa's corporate income tax apportionment formula income the company claimed was derived from sales of oil and gas extracted from the outer continental shelf).

[30] *Supra* note 1, at 772 (quoting *Cipollone*, 505 U.S. at 516).

[31] *Heublein Inc. v. South Carolina Tax Commission,* 409 U.S. 275 (1972).

[32] *Supra* note 1, at 772, n.24.

[33] 505 U.S. 214, 223 (1992).

[34] *Supra* note 1, at 772.

[35] H.R. Rep. No. 936 (Aug. 18, 1959) (accompanying H. R. J. Res. 450); S. Rep. No. 658 (Aug. 11, 1959) (accompanying S. 2524); and Conf. Rep. No. 1103 (Sept. 1, 1959) (accompanying S. 2524).

[36] H.R. Rep. No. 936, at section 101. A State or political subdivision thereof may not impose a tax upon the income of any business engaged in interstate commerce for any tax year unless, during that year, the business has maintained an office, salable inventory, warehouse, or other place of business in that State or has had an officer, agent, or representative who has maintained an office or other place of business in that State.

[37] *See* Statement of the Managers on the Part of the House Conf. Rep. No. 1103, in 105 Cong. Rec. H 17770 (Sept. 2, 1959).

> interstate commerce is left for future determination by the Congress, or in the absence of congressional action, to the courts.[38]

This statement underscores the lack of legislative intent for implicit preemption in the Senate bill. Under the "minority views" section of the report, then-Sens. Albert A. Gore Sr. and Eugene McCarthy, commenting on the narrow preemption language, observed that the bill would "deny to States the power to tax net income from certain types of transactions."[39] They added that there were no solutions in the bill "for the problems faced by trucking companies, railroads, newspapers, pipelines, or radio and television stations, just to name a few."[40] They were obviously referring to the multistate service industries, the concerns of which were left out of the bill. The House acceded to the Senate bill on those two differences in conference.[41] Thus, Congress deliberately chose in conference the narrower preemption without a time limit over a broad preemption of states' taxing authority for one year. It did not preempt any state taxing authority of income from services or intangibles.

In *Heublein*, the U.S. Supreme Court affirmed the South Carolina Supreme Court's decision to uphold the state's income tax assessment against an out-of-state liquor producer on income from wholesale sales to South Carolina customers. The state' liquor laws required the out-of-state producer to maintain an in-state representative to accept product shipments and obtain state permission before transferring them to the local distributor. The statute caused the out-of-state producer's in-state activities to fall outside P.L. 86-272 protection. The out-of-state producer argued that the state evaded the intent of P.L. 86-272. The Court disagreed, adopting a narrow interpretation of P.L. 86-272 and refusing to read the act as prohibiting such conduct, or even addressing the problem of taxing a business that undertook local activities to comply with a valid regulatory scheme. The Court found no implicit preemption of state liquor laws in P.L. 86-272, quoting the familiar statutory interpretation maxim: "unless Congress conveys its purpose clearly, it will not be deemed to have significantly changed the Federal-State balance."[42]

In *Wrigley*, the Court determined whether some activities of salesmen for an out-of-state company's sales of chewing gum were considered solicitation of orders or fell outside the scope of protection of P.L. 86-272. The Court did not consider any implicit preemption issue.

A state court determined that P.L. 86-272 did not protect some interstate motor freight trucking companies from New Jersey's corporate income tax on transportation services income in *Roadway Express*.[43] The taxpayers challenged the constitutionality of the tax and assessments against them. The New Jersey Supreme Court upheld the assessments and constitutionality of the tax. The court determined that the "limited prohibition" in the P.L. 86-272 "obviously" did not apply to the taxpayers and found that "no inference" could be drawn from the law "as to the power of the states to otherwise tax interstate commerce."[44] The court read the law's legislative history as consistent with that view.[45]

In *Matter of Disney*,[46] the worldwide entertainment conglomerate, a unitary business, challenged a New York franchise tax assessment. That assessment resulted from the department's inclusion in the sales factor numerator of the combined group's apportionment formula the New York-destination sales of DVDs by its subsidiary Buena Vista Home Video. In addition to claiming constitutional violations, Disney argued that inclusion of those sales violated P.L. 86-272, because Buena Vista's only activities in the state were solicitation of the DVD sales. Relying on the legislative history of P.L. 86-272 and upholding the assessment, the New York Court of Appeals read the preemption language in P.L.

[38] S. Rep. No. 658, at 8.

[39] *Id.* at 12.

[40] *Id.*

[41] Conf. Rep. No. 1103, at 4.

[42] 409 U.S. at 281-282 (quoting *United States v. Bass*, 404 U.S. 336, 349 (1971)).

[43] *Roadway Express Inc. v. Director, Division of Taxation*, 236 A.2d 577 (N.J. 1967).

[44] 50 N.J. 471, 236 A.2d 577, n.3.

[45] *Id.* (citing S. Rep. No. 658).

[46] *Matter of Disney Enterprises Inc. v. Tax Appeals Tribunal*, 10 N.Y.3d 392, 859 N.Y.S.2d 87, 888 N.E.2d 1029 (2008).

86-272 narrowly, determining that the term "person" referred to the entire unitary group, not the subsidiary alone.[47] The unitary group's activities in New York, which benefited Buena Vista's DVD sales, far exceeded solicitation.[48] The court observed that formula apportionment and unitary reporting existed at the time of P.L. 86-272's enactment, and that nothing in the legislative history suggested that Congress intended to alter the use or application of those methods.[49] Declining to infer any implicit preemption concerning the use of those methods, the court stated: "We will not, 'absent unambiguous evidence, infer a scope of pre-emption beyond that which clearly is mandated by Congress' language.'"[50]

III. Protection of Cloud Computing Income

P.L. 86-272 was enacted in an era when the manufacturing and sale of goods dominated the economy — long before cloud computing was contemplated. The law has no obvious application to taxation of income from sales of cloud computing.[51] For its protection to apply, there must be (a) in-state solicitation activity; (b) orders for the sale of tangible personal property; (c) orders sent out of state for approval; and (d) delivery of tangible personal property from a point outside the state.

A. In-State Solicitation Activity

Eisenstein and Bessey claim that under the implicit preemption in P.L. 86-272, "in-state business activities themselves are a necessary predicate for state taxing authority."[52] They focus on a cloud computing service provider outside the customer's state and consider the provider to be conducting no business activities in that state, although the provider interacts with the customer through the internet.

As *Wayfair* observed, in today's economy "'a substantial amount of business is transacted [with no] need for physical presence within a State in which business is conducted.'"[53] The customer may visit the cloud computing service provider's website, purchase the cloud computing service on that website, and then remotely access the provider's software, hardware, or both, in receiving the service. No support exists for the argument that P.L. 86-272 contains any implicit preemption, and P.L. 86-272 assumes that the seller has at least some in-state business activity. Otherwise, it has no apparent application at all. Virtual interaction between the provider and customer in a cloud computing transaction logically establishes in-state business activity.[54]

Under *Wayfair*, the out-of-state seller's virtual and economic presence can establish substantial nexus.[55] The cloud computing service provider's virtual interaction with the customer may occur at least partly through the customer's computer. If the customer receives software or cookies, the question arises whether those are used in solicitation activity or in providing the service itself, which goes beyond the scope of solicitation.[56]

SaaS may involve a customer's downloading software to provide a portal or interface with or transmit data to the provider's servers, enabling the customer to use the remotely accessed software. For example, in a New York State Department of Taxation and Finance advisory opinion,[57] the petitioner provided its customers remote access to proprietary software that could be used to turn photos and video clips into

[47] *Id.* at 1036-37.

[48] *Id.* In the lower court decision, *Matter of Disney Enterprises Inc. v. Tax Appeals Tribunal of New York*, 40 A.D.3d 49, 53, 830 N.Y.S.2d 614 (2007), the court determined that the activities of other members of the unitary group "greatly benefited" Buena Vista and fell within the "on behalf of" language in 15 U.S.C. section 181(a).

[49] *Id.* at 1037.

[50] *Id.* at 1036 (quoting *Cipollone*, 505 U.S. at 533).

[51] *See* Stephen P. Kranz and Mark E. Nebergall, "Sales and Use Taxes: Communications Services and Electronic Commerce, Detailed Analysis, A. Introduction," *Bloomberg Law Portfolio 1350-3rd*, n. 67 ("Pure forms of electronic commerce may be outside of the scope of Pub. L. No. 86-272 altogether because they typically will involve sales of intangible property or services rather than sales of tangible personal property.").

[52] *Supra* note 1, at 772.

[53] 138 S. Ct. at 2093 (quoting *Quill*, 504 U.S. at 308).

[54] *See id.* at 2095, 2099.

[55] *Id.* at 2099.

[56] *See* 830 Code Mass. Regs. 64H.1.7 (2017) (an internet seller will be deemed to have physical presence in the state and an obligation to collect sales/use tax if its Massachusetts sales volume in the prior year exceeds $500,000, it has at least 100 transactions, and its customers have received cookies or apps from seller, or the seller has entered into contracts with in-state content distribution networks). *See also Wayfair*, 138 S. Ct. at 2095.

[57] No. TSB-A-17(4)(S) (Mar. 1, 2017).

professional videos. Customers uploaded their photos and video clips to the petitioner's servers using interface software either accessed on the petitioner's website or downloaded from a third-party website.[58]

Downloading portal or interface software from the provider could constitute activity beyond the scope of solicitation protected by P.L. 86-272.[59] It may be tangible personal property of the provider located in the taxing state, not used in protected solicitation but as part of providing the service. When an out-of-state seller owns property in the taxing state that is not de minimis and not used in solicitation activities, P.L. 86-272 protection is lost.[60]

Even when the customer purchasing cloud computing services does not download any software, if the provider otherwise interacts with the customer virtually in providing that service, under *Wayfair*, such virtual conduct should be considered in-state activity. If so, it may fall outside protected solicitation activity under P.L. 86-272.

B. Sale of Tangible Personal Property

P.L. 86-272 contains no definition of tangible personal property. Therefore, the common ordinary meaning may apply.[61] A court interpreting the meaning may not necessarily rely on a state's statutory definition. Eisenstein and Bessey note[62] *Accuzip*,[63] in which the seller of prewritten computer software challenged New Jersey's corporation business tax assessment, asserting protection under P.L. 86-272. The seller delivered software to New Jersey businesses on CD-ROMs, including a software licensing agreement. The director of taxation argued that the transactions were sales of intangibles because licensing agreements were involved, and P.L. 86-272 did not apply. Treasury regulations defined software as a "copyrighted article" and not as a license. The New Jersey Tax Court, using those regulations as a guide, determined that the transactions were sales of tangible personal property, so P.L. 86-272 did apply. The tax court also noted that a New Jersey sales tax statute defined prewritten computer software as tangible personal property.[64]

As Eisenstein and Bessey acknowledge, states vary on whether they treat the sale of SaaS as a sale of tangible personal property or a service.[65] The authors characterize an IaaS transaction as either a data processing service or lease of computer equipment, and remote monitoring as a service.[66] Thus, IaaS and remote monitoring service transactions should fall outside the scope of P.L. 86-272.[67]

States that impose sales tax on the sale of prewritten computer software typically define it as tangible personal property.[68] If the software is not delivered in tangible media or downloaded by the customer and is merely remotely accessed, some states consider sales of remote access to software not to be sales of tangible personal property for sales tax purposes, treating them as sales of a nontaxable service.[69] Some states that impose sales tax on cloud computing consider it a sale of tangible personal property. For example,

[58] The department determined that allowing remote access to petitioner's proprietary software was subject to sales tax as selling access to prewritten computer software and defined as tangible personal property under New York law.

[59] *See* Illinois Department of Revenue ST 17-0006-GIL (Mar. 2, 2017) ("If a provider of a service provides to the subscriber an API, applet, desktop agent, or a remote access agent to enable the subscriber to access the provider's network and services, the subscriber may be receiving computer software.").

[60] *See, e.g.*, *Consolidated Accessories Corp. v. Franchise Tax Board*, 161 Cal. App. 3d 1036, 208 Cal. Rptr. 74 (1984) (out-of-state corporation entering into consignment agreements to sell its goods in California stores was not entitled to P.L. 86-272 protection); *Olympia Brewing Co. v. Department of Revenue*, 266 Ore. 309, 511 P.2d 837 (1973), *cert. denied* 415 U.S. 976 (1974) (out-of-state beer seller with kegs in the state not entitled to P.L. 86-272 protection); and Virginia Department of Taxation ruling P.D. 12-36 (Mar. 28, 2012) (ownership of server equipment in Virginia would exceed P.L. 86-272 protections).

[61] *Pomco Graphics Inc. v. Director, Division of Taxation*, 13 N.J. Tax 578, 587 (Tax Ct. 1993).

[62] *Supra* note 1, at 771, n.17.

[63] *Accuzip Inc. v. Director, Division of Taxation*, 25 N.J. Tax 158 (Tax Ct. 2009).

[64] *Id.* at 174.

[65] *Supra* note 1, at 771, n.17.

[66] *Id.* at 771.

[67] *See* MTC statement, *supra* note 24. *See also* Virginia Department of Taxation ruling P.D. 06-38 (Apr. 5, 2006) (out-of-state lessor of heavy equipment located in Virginia not protected by P.L. 86-272.); and Virginia Department of Taxation ruling P.D. 16-135 (June 24, 2016) (rental of servers in Virginia not protected under P.L. 86-272).

[68] *See* Streamlined Sales and Use Tax Agreement definition of prewritten computer software as tangible personal property, which its member states were required to adopt. Many states have followed suit. *See, e.g.*, 830 Code Mass. Regs. 64H.1.3(2).

[69] *See, e.g.*, Colorado Department of Revenue GIL 17-012 (July 28, 2017); Florida Department of Revenue TAA 17A-010 (Apr. 25, 2017); and Vermont Department of Taxes Formal Ruling 17-07.

Massachusetts considers the sale of SaaS to be a sale of tangible personal property, as a transfer of the right to use prewritten computer software installed on a remote server, regardless of where it is located.[70] Pennsylvania includes in its statutory definition of tangible personal property "canned software . . . whether electronically or digitally, delivered, streamed, or accessed."[71] New York considers the sale of remote access to prewritten computer software as "constructive possession" of the software and therefore a sale of tangible personal property.[72]

Other states that impose sales tax on cloud computing consider it to be the sale of a service, not tangible personal property. Texas treats SaaS as a taxable data processing service.[73] Connecticut treats SaaS as a taxable computer or data processing service, including "retrieving or providing access to information."[74]

C. Order Sent Out of State for Approval

P.L. 86-272 requires that orders for sales of tangible personal property be sent out of state for approval. In many cases, online sales appear to occur when the purchaser takes the final step of accepting the offer, under terms provided by the seller. To take advantage of P.L. 86-272, the cloud computing provider would have to establish that an order was accepted out-of-state. How will the place of approval be determined? What if the provider does not know where the order is approved?[75] When all interaction between the provider and customer is virtual, it is likely that there will be no out-of-state approval of orders.

D. Delivery of Tangible Personal Property

"Delivery" is not defined in P.L. 86-272. Eisenstein and Bessey state that cloud computing transactions typically do not involve the installation of software on an end user's computer.[76] Even assuming cloud computing is considered tangible personal property under P.L. 86-272, has there been delivery from a point outside the state if software is remotely accessed and not downloaded to the customer's computer? Remote access to software, such as SaaS, may not be considered a delivery under P.L. 86-272. For example, Colorado and Georgia require that the software be delivered in tangible media before the sale becomes taxable as a sale of tangible personal property.[77] Kansas and Vermont impose tax on the sale of prewritten computer software electronically delivered, but the software must be downloaded to be considered delivered.[78] If *Accuzip* had involved remote access to software, as opposed to software delivered to the customer on a CD-ROM, the New Jersey Tax Court might have determined that no delivery had occurred under P.L. 86-272.

IV. Post-*Wayfair* Changes to Nexus Analysis for Cloud Computing Income

Eisenstein and Bessey argue that the due process clause might provide some defense for the cloud computing service provider against state taxation of its interstate income when the provider has no contact with the state other than its customers being located there.[79] They contend that the provider may not know where customers remotely accessing its software are located, and argue that in due process nexus analysis[80] the inquiry should focus on the taxpayer's contacts with the taxing state, not the taxpayer's contacts with its customers.[81] According to Eisenstein and

[70] 830 Code Mass. Regs. 64H1.3 (3); Massachusetts Department of Revenue Letter Ruling 12-8 (Nov. 8, 2013).

[71] Pennsylvania Department of Revenue SUT 17-002 (May 17, 2017) (citing 72 Pa. Stat. section 7201(m)(2)).

[72] *See* N.Y. Tax Law sections 1101(b)(6) and 1105(a); New York State Department of Taxation and Finance TSB-A-17(4)(S) (Mar. 1, 2017); and New York State Department of Taxation and Finance TSB-A-17(9)(S) (July 6, 2017).

[73] Texas Comptroller of Public Accounts, PLR 151250584 (May 30, 2017).

[74] Conn. Gen. Stat. 12-407(a)(37)(A); Connecticut Department of Revenue Services Ruling No. 2017-6 (Sept. 21, 2017).

[75] *See* Kranz and Nebergall, *supra* note 51. ("What does it mean to send an order outside the state when the order is being sent over the internet to a server whose location may not even be known to the seller?").

[76] *Supra* note 1, at 770.

[77] Colorado Department of Revenue GIL 17-012 (July 28, 2017); and Georgia Department of Revenue LR SUT-2017-04 (Feb. 23, 2017).

[78] *See* Kansas Department of Revenue EDU-71R; Vermont Department of Taxes Formal Ruling 17-07.

[79] *Supra* note 1, at 770.

[80] *Id.* at 774. The due process inquiry looks to "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954).

[81] *Supra* note 1, at 770.

Bessey, the provider's market activity should be ignored. However, the typical cloud computing transaction would likely involve a contractual relationship between the provider and the customer, possibly requiring training, troubleshooting, and other support activities involving extensive interaction.[82] In such a relationship, the provider should know, or be able to find out, where the customer is located or is using the service.

Wayfair makes clear that due process analysis includes consideration of the benefits that the state provides to the seller's market, such as police and fire department protection for customers' goods and public roads and municipal services for access to customers.[83] The size of the seller's market in the state, as well as the seller's virtual presence there, are both relevant to the due process analysis in establishing that the seller "availed itself of the substantial privilege of carrying on business in the state."[84] The seller's "substantial virtual connections to the state" cannot be ignored in making the substantial nexus determination.[85]

Noting the "significant parallels" between the due process and commerce clause standards[86] for determining when a state may levy a tax, *Wayfair* observed that the same "reasons given in *Quill* for rejecting the physical presence rule for due process purposes" apply as well to the commerce clause substantial nexus determination.[87] *Wayfair* concluded that "physical presence is not necessary to create a substantial nexus."[88] *Wayfair* determined that the respondents' quantity of business showed such availment and met the South Dakota statutory annual sales threshold of more than $100,000 or at least 200 separate transactions. *Wayfair* found nexus "clearly sufficient," based on the respondents' economic and virtual contacts with the state.[89]

A cloud computing service provider might have no physical presence in the market state, but in view of *Wayfair*, the quantity of the provider's economic and virtual contacts in that state (either through its marketing efforts or in remotely providing cloud computing services) should be considered in determining due process minimum contacts and commerce clause substantial nexus.[90] Lack of the provider's physical presence in the taxing state, by itself, should be no obstacle to satisfying either constitutional provision.[91]

V. Conclusion

Eisenstein and Bessey claim that P.L. 86-272 offers cloud computing service providers protection from a market state's income tax when they conduct no business activities in that state. The narrow preemption in P.L. 86-272 applies only to state taxation of net income derived in interstate commerce from sales of tangible personal property when the out-of-state seller's in-state activities are limited to solicitation of orders for the sale of tangible personal property, the order taken in-state is approved out-of-state, and the purchased item is shipped from a point outside the state. The statutory language does not preempt state taxation of income from services, which likely includes cloud computing. Moreover, no support exists in the legislative history of P.L. 86-272 or court decisions for implicit preemption of state taxing authority concerning income from services.

A cloud computing service provider lacking physical presence in the market state should not assume P.L. 86-272 provides any protection against the market state's income tax. The provider's virtual interaction with the customer establishes in-state business activity. A sale of cloud computing services may not be considered a sale of tangible personal property under P.L. 86-272, and in that case, the law would not apply. Further, even assuming the provider is engaged in the sale of tangible personal property, the

[82] *See* Kranz and Nebergall, *supra* note 51, Detailed Analysis.

[83] 138 S. Ct. at 2096.

[84] *Id.* at 2099.

[85] *Id.* at 2095. The Court noted the "continuous and pervasive virtual presence of retailers today."

[86] *See Complete Auto*, 430 U.S. at 274.

[87] 138 S. Ct. at 2093.

[88] *Id.*

[89] *Id.*

[90] *See id.*

[91] Of course, the provider's economic and virtual presence must be more than de minimis, and the tax must pass the three other prongs of the *Complete Auto* test. Sourcing and apportionment issues can certainly arise in the context of cloud computing income, but those subjects are beyond the scope of this article.

provider's virtual interaction with the customer could exceed the scope of protected activity. If the transaction involves downloading software to the customer's computer, and that software is used in providing the service, such activity would exceed solicitation and fall outside P.L. 86-272. An order received virtually may not have been approved out of state, causing the loss of P.L. 86-272 protection. Assuming the cloud computing product is considered tangible personal property, there may not be any delivery of the product from outside the state, as required by P.L. 86-272, when the cloud computing customer has only remote access to software or hardware.

P.L. 86-272 may provide little protection for cloud computing income. Absent such protection, a cloud computing service provider's virtual and economic presence in the market state can establish income tax nexus, regardless of any physical presence, particularly post-*Wayfair*. ■