

In the Wake of the MTC's P.L. 86-272 Project

by Brian Hamer



Brian Hamer

Brian Hamer is counsel to the Multistate Tax Commission. He was previously director of the Illinois Department of Revenue from 2003 to January 2015. Before that, he was deputy director of the Chicago DOR and chief assistant corporation counsel at the city's

Department of Law. The views expressed in this article are not necessarily the views of the MTC or its members. The author expresses appreciation to his MTC legal colleagues for sharing their deep knowledge about state tax law.

In this installment of Revenue Matters, Hamer argues that adopting the MTC's revised statement on P.L. 86-272 on a prospective basis, together with nexus thresholds, would protect state revenues, show that states can limit burdens on interstate commerce, counter federal preemption of state taxing authority, and provide fair notice to internet sellers navigating the federal statute's requirements.

It has been a year since the Multistate Tax Commission adopted updates to its Statement of Information on Public Law 86-272.¹ As many in the state and local tax arena know, these updates address how P.L. 86-272 applies to modern business activities, most notably activities

conducted via the internet.² In particular, the revised statement provides that (as a general matter) when a business interacts with a customer via its website or app, the business engages in a business activity within the customer's state. This in turn means that P.L. 86-272 does not shield an internet seller from income tax filing and payment obligations imposed by states where the seller's customers are located — unless the seller's activities are limited to solicitation of orders for sales of tangible personal property.

In the wake of the MTC's adoption of the revised statement, many internet sellers are anxious to understand the current status of P.L. 86-272 and what may occur next. The revised statement of course is not self-executing: States may elect to adopt it in whole, in part, or not at all. This matter is further complicated because states do not have the power to dictate how P.L. 86-272 should be construed — it is, after all, a federal statute. But the reality is that Congress failed to designate an administrative body to provide binding guidance to taxpayers regarding the statute's meaning. It therefore necessarily falls on state revenue departments to decide (subject to court review) how they will apply the statute to activities that were never contemplated by the statute's drafters, including activities conducted via the internet.

Thus far, the two largest income tax states have picked up the baton. First, on February 14 the California Franchise Tax Board issued a tax

¹Multistate Tax Commission, "P.L. 86-272 Statement of Information."

²P.L. 86-272, enacted in 1959, provides in key part that "no state or political subdivision thereof" may impose a net income tax "on 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 person . . . are the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property that are sent outside the state for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the State." The statute is codified at 15 U.S.C. sections 381-384.

advisory memorandum that contains the substance of the statement's new internet provisions.³ An FTB spokesperson has explained that the memorandum is intended to provide legal advice to divisions within the board, including presumably auditors examining the activities of out-of-state businesses selling into California. Given that it is a public document, the memorandum also serves as notice to taxpayers.⁴ Second, on April 29 the New York Department of Taxation and Finance issued draft corporate income tax regulations that include provisions closely tracking the internet provisions of the revised statement.⁵

Various publications have reported that still other states are actively considering how to proceed. And interestingly, some practitioners have publicly called upon additional states to provide guidance.⁶

Reprising the Statement's Legal Foundation and Recent Commentary

Before addressing what may come next, it is important to understand the revised statement's legal foundation. Since I have previously written about P.L. 86-272's history and detailed the arguments and sources that provide support for the revisions,⁷ I will simply highlight the key points here:

- The plain language of P.L. 86-272 does not prohibit states from imposing income tax on businesses that lack an in-state physical presence; the statute in fact makes no mention of physical presence at all.
- In 1959, when Congress passed the bill that became P.L. 86-272, it considered four alternative bills that would have expressly preempted states from imposing income tax on businesses that lacked an in-state physical presence. Congress failed to enact any of those alternative bills.

- It was settled law in 1959, in the analogous realm of personal jurisdiction, that a business could have sufficient presence in a state to be sued there even if it did not have an in-state physical presence.
- The U.S. Supreme Court has expressed on multiple occasions that federal statutes should not be interpreted to preempt traditional state powers, including taxing authority, unless there is a "clear and manifest" congressional intent to do so.⁸
- The majority opinion authored by Justice Anthony M. Kennedy in *Wayfair* (which did not address P.L. 86-272) contains a number of observations regarding internet activities that are highly relevant to the question of how P.L. 86-272 applies to business activities conducted via the internet. For example, the opinion states that an internet seller "may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term."⁹ These observations suggest that the Court would have little difficulty concluding that sellers that interact with customers via the internet engage in business activities within the states where their customers are located.
- When a customer visits a vendor's website, the website transmits software to the customer's computer. This software, once resident on the customer's in-state computer, facilitates the interaction between the customer and the retailer.
- P.L. 86-272's legislative history indicates that Congress's intention when passing the statute was to ensure that the "mere solicitation of orders" would not subject out-of-state businesses to tax.¹⁰

³Franchise Tax Board, TAM 2022-01.

⁴See Amy Hamilton, "Practitioners Weigh In as P.L. 86-272 Project Moves to States," *Tax Notes State*, May 30, 2022, p. 933.

⁵The draft New York regulations.

⁶See, e.g., "States Urged to Issue Guidance on Internet Biz Tax Shield," *Law 360*, July 12, 2022.

⁷See Hamer, "An Insider's View of the MTC's P.L. 86-272 Project," *Tax Notes State*, Mar. 22, 2021, p. 1213.

⁸*Department of Revenue of Oregon v. ACF Industries Inc.*, 510 U.S. 332, 345 (1994). See also *Heublein Inc. v. South Carolina Tax Commission*, 409 U.S. 275 (1972) (interpreting P.L. 86-272).

⁹*South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080, 2095 (2018).

¹⁰Senate Rep. No. 658, 86th Cong. 1st Sess. (1959).

These points strongly support the view that when an internet seller interacts with a customer via its website or app, the seller engages in business activities within the customer's state.¹¹ And as a consequence, P.L. 86-272 provides no protection to an internet retailer unless its business activities are limited to solicitation of orders for sales of tangible personal property.

In my previous P.L. 86-272 article, I responded to various arguments raised by critics of the revised statement. I will not repeat my responses here. Since the MTC's adoption of the revised statement, tax practitioners have published additional commentary. This commentary has generally fallen into two categories.

Most broadly, critics have complained that the updates to the statement would undo P.L. 86-272's protections and would effectuate a substantial policy change.¹² These objections, however, reflect a misunderstanding of what the MTC did. The commission did not seek to change the law (which again, only Congress can do) or to engage in policymaking. To the contrary, over the course of many months, the members of the MTC work group charged with developing the updates engaged in a process of statutory interpretation.¹³ Specifically, they considered (in addition to other subjects) how P.L. 86-272 applies to activities conducted via the internet. And they reached a result that is supported by the statute's language and history.¹⁴ Under these circumstances, policy objections directed at the revised statement are misplaced.

More narrowly, some critics have raised the concern that small internet sellers will experience excessive compliance burdens if P.L. 86-272 does not provide protection, pointing out that many internet vendors engage in activities that extend

beyond solicitation. As I will discuss shortly, states should take this concern seriously. But the reality is that P.L. 86-272 is ill-suited to protect small businesses, particularly small internet sellers.

By its terms, P.L. 86-272 protects businesses to the extent that they engage in solicitation of orders for sales of tangible personal property; the statute does not protect businesses because they are small or because they have few contacts with a taxing state. In fact, the line drawn by the statute between protected and unprotected businesses is entirely unrelated to business size or to the magnitude of sales that a business has in a taxing state. As a result, the law acts to protect large businesses that limit their in-state activities to solicitation of orders for tangible goods, but withholds protection from small businesses that have a modest in-state physical presence or that sell services or intangible property. This has been true since P.L. 86-272 became law.

The Willis Committee, which was tasked by Congress shortly after P.L. 86-272's passage to study state taxation, identified this reality more than five decades ago. In its final report, the committee stated: "Some small companies . . . were left with a broad scope of potential income tax liability even after the enactment of [P.L. 86-272]. In this respect, it can be argued that *the statute failed to give protection in cases in which protection was appropriate.*"¹⁵ This failure, moreover, has never been more consequential than it is today, given that so many small retailers contract with market facilitators that store sellers' inventory in warehouses located near potential customers. This common business practice negates any protection that P.L. 86-272 would otherwise provide.

What Comes Next?

It seems inevitable that revenue department auditors at some point will direct their attention to internet sellers that have not filed income tax returns (in the auditors' state) and that those sellers in turn will claim P.L. 86-272 protection.

¹¹The revised statement notes that when a business presents static text or photos on its website, that presentation does not in itself constitute a business activity within those states where the business's customers are located.

¹²For example, a recent article by practitioners that critiqued New York's draft regulations was: Joseph N. Endres, Christopher L. Doyle, and K. Craig Reilly, "New York Proposes to Drastically Limit P.L. 86-272 Protections," *Tax Notes State*, May 30, 2022, p. 885.

¹³The work group consisted of representatives from a dozen states.

¹⁴The updates, as drafted by the work group, were later approved by the MTC's Uniformity Committee and were subject to a public hearing conducted by professor emeritus Robert Desiderio, former dean of the University of New Mexico School of Law. Then, following some non-substantive changes, they were adopted by the commission.

¹⁵Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, House Rept. No. 1480, 88th Cong., 2d Sess. (1964), chapter 13 ("Impact of Public Law 86-272"), at 431 (emphasis added).

This means that questions regarding the application of P.L. 86-272 to internet activities cannot be avoided forever. Therefore, states and taxpayers have decisions to make.

States. States must decide whether to provide upfront guidance as to how they will apply P.L. 86-272 to internet activities or wait until their auditors raise the issue. For multiple reasons, it seems that the far better course is to follow in the footsteps of California and New York and provide upfront guidance. First, providing notice generally advances tax fairness. This is particularly true in situations like this one in which taxpayers must decide not whether to pay tax but rather where to pay tax (that is, to their home state or to the states where their customers are located). Second, as a practical matter, taxpayers are more likely to voluntarily comply if they have been given a heads-up, which is unquestionably in the interest of tax agencies.

There is much to say about this second point. Taxpayers are more likely to litigate if the only notice they receive is in the form of a large tax assessment, either because they feel they have no alternative or simply as a matter of principle. And although states will have strong legal arguments to support assessments that are issued to internet vendors (that engage in non-solicitation activities), there are no guarantees in litigation. This is particularly so if a judge feels that the state has not given taxpayers reasonable notice about what the judge perceives to be an arcane matter of law. On the other hand, if a state provides upfront guidance, internet sellers are more likely to comply, particularly if they learn that the state can point to substantial legal authority for its position — and if it is apparent that the state is directing its efforts to competitors as well.

States that adopt the revised statement's internet provisions should also consider announcing that they will apply those provisions on a prospective-only basis. Failure to do so may well discourage voluntary compliance, since sellers will fear that filing a return for the current year will cause tax authorities to examine prior years (and in many states, there is no statute of limitations for years that a taxpayer has not filed a return). Tax administrators might further announce — if they have the discretion to do so — that they will apply the internet provisions on an

exclusively prospective basis only with respect to those sellers that come into voluntary compliance by a stated deadline. This would incentivize sellers to begin paying tax promptly and could well result in more revenue than relying on assessments and protracted litigation to compel compliance.

One final thought regarding states that choose to rely on the audit process rather than issuing upfront guidance: Courts may interpret previously issued, broadly drafted state laws or guidance to suggest that activities conducted via the internet are protected by P.L. 86-272. It is important, therefore, for revenue departments to review guidance currently in place and revise guidance that might create a misimpression among taxpayers and courts. Revenue authorities should not assume that silence on the subject of internet activities necessarily preserves their options.

Taxpayers. Whether or not a state issues upfront guidance, internet retailers should think hard before playing the audit lottery. Given the substantial arguments supporting the conclusion that non-solicitation activities conducted via the internet are not protected by P.L. 86-272, sellers take on significant risk if they fail to pay tax to a state where their customers are located. One of many questions sellers should ask themselves: In this post-*Wayfair* world, how confident can they be that a judge would accept the argument that internet sellers do not engage in business activities in customers' states?¹⁶

Back to States. State policymakers should recognize that placing multistate income tax filing and payment obligations on small businesses, or more specifically on businesses with minimal in-state contacts, serves no good purpose and has multiple downsides. First, it generates little or no revenue. Second, it imposes burdens on businesses that often have few resources to spare. Third, it requires tax administrators responsible for processing returns and addressing taxpayer issues to apply scarce resources to unproductive activities.

¹⁶ See, e.g., *Wayfair* at 2095 (“a company with a website accessible in South Dakota may be said to have a physical presence in the State via the customers’ computers”).

Also, subjecting small businesses to those burdens provides powerful talking points to interest groups seeking federal legislation to further restrict state taxing authority. At the moment, tax preemption legislation is unlikely. But one can hardly say that preemption will not rear its ugly head down the road.

States that adopt the revised statement's internet provisions (and other states as well) should therefore adopt income tax nexus thresholds — analogous to the thresholds before the Supreme Court in *Wayfair*. Carefully designed state thresholds are the most effective and targeted way to protect small businesses, far better than P.L. 86-272. The MTC adopted a model factor presence nexus statute almost two decades ago. This model in effect shields businesses from income tax obligations if their in-state sales, payroll, and property fall below specified amounts.¹⁷ It is particularly noteworthy that both California and New York have income tax nexus thresholds in place.¹⁸

Adopting both reasonable nexus thresholds and the internet provisions in the revised statement would protect state revenues, show Congress that states are capable of limiting burdens on interstate commerce, and counter future efforts to restrict state taxing authority, while providing fair notice to internet sellers seeking to navigate the requirements of P.L. 86-272. ■

¹⁷The MTC work group referenced the model in the introduction of the revised statement and proposed making the model an addendum to the statement.

¹⁸Thirteen states have enacted nexus thresholds to date: Alabama, California, Colorado, Connecticut, Hawaii, Maine, Massachusetts, Michigan, New York, Ohio, Pennsylvania, Tennessee, and Texas.




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