Interstate Commerce Initiative

NTUF
NATIONAL TAXPAYERS UNION FOUNDATION

Issue Brief

MAY 25, 2022

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States Preparing Workaround of P.L. 86-272, A Key Taxpayer Protection for Interstate Businesses

On Valentine's Day this year, California's Franchise Tax Board (FTB) announced that it wanted relationships with a lot more out-of-state businesses. Unfortunately for these businesses, the FTB's idea of a relationship is an expensive one, and it's not asking.

In a recent guidance, the FTB announced that it intends to reinterpret an existing federal law in order to allow itself to impose income tax obligations on out-of-state businesses. Just a couple months later, New York's Department of Taxation and Finance followed suit with draft regulations largely mirroring those of the FTB.

In so doing, these states could open the floodgates for the roughly 2.5 million online retailers to have to pay income taxes to many more states, vastly increasing compliance burdens. In the meantime, this sends a strong message to out-of-state businesses that they will use the most tangential of connections as excuses to grab at more tax revenue.

The law being reinterpreted, P.L. 86-272 or the Interstate Income Act of 1959, prevents states from imposing income tax obligations on out-of-state businesses whose activity within the state is limited to solicitation of orders. In other words, a business located in Iowa could not be subjected to income tax obligations in California if it distributed a mail-order catalog in California, so long as orders submitted by Californians were fulfilled from outside of California.

Key Facts:

Following a statement by the Multistate Tax Commission (MTC), California and New York have become the first states to move towards sweeping changes to how states tax the income of out-of-state businesses.

Though P.L. 86-272, or the Interstate Income Act of 1959, is meant to protect out-of-state businesses from facing income tax obligations in states where they lack physical presence, the proposed workarounds would subject most e-retail businesses to these obligations anyway.

Absent Congressional intervention, this could create new, significant compliance burdens for small businesses still reeling from the pandemic.

Though P.L. 86-272 was obviously written well before the internet existed, this principle applies to online businesses as well. After all, if an out-of-state business with a salesperson soliciting sales within a state still was afforded the protection of the Interstate Income Act, why would an out-of-state online business with nothing more than a website not be?

Yet just as the Supreme Court's decision in *South Dakota v. Wayfair* represented the culmination of decades of state efforts to overturn the physical presence standard in sales tax under *Quill v. North Dakota*, states now seem to be turning their attention to getting around P.L. 86-272. That's a problem not just for the small businesses who stand to face yet more complexity in filing their taxes each year, but also for the future of federalism and good governance.

Background

In the aftermath of *Wayfair*, the primary focus was on the impact that the replacement of the physical presence standard with economic nexus would have for sales tax compliance burdens. Yet NTUF warned early on that it would not be long before states attempted to apply the logic underpinning *Wayfair* to other taxes as well.

Unfortunately, it took less than two years for that warning to be proven correct. Starting in 2020, Hawaii became the first state to effectively apply the economic nexus standards under *Wayfair* to income taxes, claiming income tax power over any company engaging in 200 or more business transactions or deriving gross income of over $100,000 from Hawaii sources. Yet even here, Hawaii did not attempt to get around the protections offered to taxpayers under P.L. 86-272.

That's what made it so significant when the Multistate Tax Commission (MTC), an intergovernmental tax agency, published a statement expressing its view that taxpayers could forfeit the right to protection under P.L. 86-272 under some counterintuitive circumstances. Below is a list of activities that MTC asserts would lose a business the protection of P.L. 86-272, along with analysis of some of these points:

- Offering post-sale customer service via email or chat if it is initiated through a button on the business's website.

Note that MTC does not claim that post-sale customer service delivered via email loses a business the protection of P.L. 86-272 if a customer finds the business's customer support email address and emails the business independently, if the customer calls a customer service representative over the phone based outside of the state, or if the business offers an FAQ page on its website — distinctions that are hard to describe as anything but arbitrary.

- Offering post-sale customer service in the form of remote repairs or automatic software updates.

This provision would affect nearly every business selling software, or even offering free software necessary to use a tangible physical product, as nearly all such software automatically updates.

- Soliciting and receiving branded credit card applications through its website.
- Offering and selling extended warranty plans for products purchased through its website.
- Posting open job descriptions and enabling viewers to apply through the website.
- Contracting with a marketplace facilitator that has fulfillment centers in-state.

Tax treatment of businesses that utilize marketplace facilitators was a controversial element of post-*Wayfair* economic nexus sales tax laws as well, so it is no surprise to see the issue pop up again with business income taxes. However, businesses contracting with the largest marketplace facilitators, such as Amazon, often end up with inventory in states all around the country.

What's more, businesses contracting with marketplace facilitators often have little interaction with their inventory once it is sent to a fulfillment center. Once inventory is shipped to a fulfillment center, it is the facilitator that is in charge of fulfilling orders and ensuring they reach their final destinations. For all intents and purposes, the last step of the order fulfillment that the third-party seller is involved in is in sending their inventory to a fulfillment center.

It is worth asking how different this arrangement truly is than sending inventory from out-of-state to an in-state postal service processing center. There too, it is not the business itself that is responsible for ensuring that their inventory reaches the customer, even though their inventory is technically stored in-state.

And setting aside the legal arguments, businesses taking advantage of marketplace facilitators' fulfillment programs all over the country are often small. Subjecting them to nationwide state tax obligations takes away much of the benefit of marketplace facilitation — namely, allowing small businesses without the resources to manage a nationwide operation to access a national market.

- Selling intangible, or digital, goods, such as streaming music.
- Placing digital "cookies" on customers' devices for specific purposes.

MTC claims that the use of cookies for certain "sales-specific" purposes would not lose a business the protection of P.L. 86-272, namely:

> "...to remember items that customers have placed in their shopping cart during a current web session, to store personal information customers have provided to avoid the need for the customers to re-input the information when they return to the seller's website, and to remind customers what products they have considered during previous sessions."

Yet on the other hand, MTC's examples of uses of cookies that would void P.L. 86-272 are nearly impossible to avoid. MTC describes the use of cookies "to adjust production schedules and inventory amounts, develop new products, or identify new items to offer for sale" as losing the protection of P.L. 86-272, activities so broad that it would be difficult for any business to separate from *any* information gained from customers.

This isn't the first time that states have attempted to use cookies to get around tax protections. As part of the aforementioned state efforts to get around *Quill*, Ohio and Massachusetts instituted a so-called "cookie nexus," claiming that businesses which placed cookies on customers' computers or devices had physical presence. Both states replaced their cookie nexuses with more traditional economic nexus laws in the aftermath of *Wayfair*, but it illustrates how commonly states attempt to apply absurd interpretations of the role modern technology should play in established law in order to grab more tax revenue.

Taken together, MTC's guidance is a blueprint for the majority of online businesses to lose the protection of P.L. 86-272. Consider that MTC recommends that any of the above result in the forfeiture of P.L. 86-272 protections. How many online businesses can say that they do not violate *any* of the above prongs, or even come close enough to doing so to satisfy overzealous tax bureaucrats?

The States' Turn

If any states need little encouragement to expand their tax authority over residents over other states, they are California and New York. It was therefore not surprising when California and New York became the first two states to apply the MTC's interpretation of P.L. 86-272 to its own tax code.

Both states' guidances addressing the issue are little more than the MTC's guidance copied and pasted onto the FTB's website. Just like with the MTC's own statement, the FTB explicitly references *Wayfair* as the basis for reinterpreting P.L. 86-272, then runs down scenarios which are largely the same as those used by the MTC. New York, meanwhile, acknowledges that its draft rules are largely modeled after the MTC's model statute.

Another scenario mentioned by MTC and the FTB could have significant implications. The FTB specifically mentions a case in which an out-of-state business has an employee who telecommutes from California and performs duties outside of those necessary for sales of tangible personal property, describing that as a case where the business would lose the protection of P.L. 86-272.

Much of the focus on the tax implications of telecommuting have focused on individual income taxes, but California here provides a reminder that states can attempt to abuse remote work arrangements for tax purposes as well. Most businesses who allow their employees to work remotely may not even consider that such a decision could have income tax implications.

As remote work becomes more and more common, it will only become more necessary for Congress to provide clarity to businesses considering allowing employees to telecommute. Until it does, businesses will continue to be trapped in new income tax obligations by merely offering their employees more flexible work arrangements.

Another area where California departs from the MTC is on the question of retroactivity. FTB officials have stated that they intend to apply the new interpretation of P.L. 86-272 to all open tax years, which for California means four years retroactively or more.

That means that online businesses that filed their taxes years ago with no reason to think that California would claim any income tax revenue from them could now find FTB officials knocking on their doors. What's more, it means that e-retail businesses that use cookies or maintain a "careers" page on their websites cannot change that going forward to avoid income tax obligations to California — in California's eyes, they already owed taxes.

Furthermore, while states generally allow businesses and individuals to claim a credit for taxes paid to other states, businesses have of course already filed tax returns for the years that California would be claiming income taxes for. Paying these new income tax liabilities would require businesses to attempt to amend their already-filed returns with other states to claim those credits against California taxes paid — some of which allow for fewer open tax years as California does.

Retroactivity is a consistent issue when it comes to reinterpretations of existing legal standards because officials can claim that there is nothing retroactive at all — they are only clarifying obligations businesses always had. That's a disingenuous line of argument, however, as businesses cannot and should not be expected to predict future judicial and legal changes.

California is doing this with P.L. 86-272. Based on an MTC statement with no legal authority published less than a year ago, California is announcing that it is reinventing the conventional interpretation of P.L. 86-272 going back four years or more. If taxpayers have no certainty that the tax laws they must grapple with at any given time will not be changed retroactively years later, managing tax obligations becomes infinitely more difficult.

Legislative Fixes

Though the internet has brought with it many positive changes, state officials have increasingly used it as an excuse to blur the once-fairly clear borders between states' respective jurisdictions. Legislative solutions are needed to return states to more clearly demarcated borders.

The simplest and most comprehensive solution would be the Business Activity Tax Simplification Act (BATSA), introduced by Rep. Steve Chabot in the 116th Congress. BATSA would address many of the federalism issues that have arisen over the last couple decades, particularly since *Wayfair*.

The first improvement BATSA would make would be to return business taxes to the physical presence standard. States would be unable to impose business tax collection obligations on out-of-state individuals or businesses unless they have some form of physical presence in the taxing state. That alone would prevent states from applying confusing and overlapping economic nexus standards to tax policy.

The other important change BATSA would make on P.L. 86-272 would be to include digital goods and services under this protection, the same as traditional goods. The MTC's statement, and California and New York's subsequent ones, rely greatly upon the omission of digital goods and services from P.L. 86-272's protection, largely because digital goods and services did not exist when P.L. 86-272 was passed.

Yet there is little reason why digital goods and services should face differing tax treatment to traditional goods. BATSA would help to rectify this imbalance in our tax code.

Conclusion

California and New York are not the first states to impose income tax obligations on out-of-state businesses, but they are the first to essentially bypass P.L. 86-272. Should other states follow suit, the increasingly overlapping nature of state tax jurisdiction will only intensify.

Unfortunately, it is quite clear that the MTC, as well as California and New York, are not seriously considering the impact that such drastic expansions of tax authority would have on businesses. None of the MTC statement, the California guidance, or the New York draft rule so much as mention the compliance burdens such changes could have on businesses selling goods around the country, even though it would largely be smaller businesses without nationwide physical presence that would be affected. That's a concerning omission for given such sweeping proposed changes to how state business taxes are handled.

Congress must take seriously its responsibility to safeguard interstate commerce and ensure that the increasing interconnectedness of our society and markets do not present undue opportunities for states to expand their tax jurisdictions. After all, the surest way to stifle innovation is to make the tax environment for e-retail businesses so dauntingly complex that only large established firms can handle it.

About the Author

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