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California Prepares to Expand Tax Jurisdiction, Erroneously Citing *Wayfair* Decision

California recently decided to become the first state to follow the Multistate Tax Commission (MTC) in its new interpretation of P.L. 86-272, or the Interstate Income Act of 1959, a federal law designed to protect businesses from income tax liability in a state where they have no property or employees. The MTC's new interpretation pretends to adhere to the language of P.L. 86-272 while fundamentally changing the spirit of the law. In essence, it allows states to bypass the protections of P.L. 86-272 for businesses with all but the most basic of websites, subjecting them to multiple tax burdens in many more states.

To justify this overreach, California and the MTC have claimed to draw inspiration from a recent U.S. Supreme Court decision in *South Dakota v. Wayfair*. Yet problematic as the *Wayfair* decision has ended up being for businesses around the country, it in no way provides justification for unfettered expansions of state tax jurisdictions.

Background

The rise of the internet and the ensuing increased digitization of the economy has led states to seek to overturn long-standing rules about what gives a state the power to assess tax liability on businesses located out-of-state. Up to now, nexus was generally

Key Facts:

Recent state efforts to bypass P.L. 86-272, which aims to protect out-of-state businesses from income taxation obligations in states where they lack physical presence, have pointed to the 2018 Wayfair decision as justification.

However, this decision covers sales taxes alone, and is silent on the issue of business income taxation.

What's more, the Court in Wayfair aimed specifically to correct an imbalance between sales tax obligations for brick-and-mortar sellers and online sellers — an imbalance that does not exist for business taxes.

established for a business on the basis of having physical presence in that state — be it an employee or an office, a warehouse, or a storefront.

This has recently changed for sales taxes. Here, the physical presence standard was not codified into law, instead coming from Supreme Court decisions in *National Bellas Hess v. Department of Revenue of Illinois* (1967) and *Quill Corp. v. North Dakota* (1992). States drafted so-called "kill *Quill*" laws, seeking a Supreme Court battle to receive judicial approval for sales tax collection and remittance requirements on the basis of "economic nexus," or a sustained economic presence in a state.

In *Wayfair*, one of these laws passed by South Dakota which established sales tax nexus for companies with 200 transactions or $100,000 in sales in South Dakota in a calendar year, was ruled to be constitutional by the Court.

Small businesses in particular have been impacted by the decision, as they were suddenly faced with the challenge of having to collect and remit sales taxes in states all across the country. Businesses that previously struggled to navigate the differences in sales tax definitions, exemptions, and rates in just one or two states suddenly found themselves expected to do the same in many more, often nationwide.

Meanwhile, some states predictably skirted the intended protections for businesses as much as they could, leading to insufficient (or in one case, nonexistent) safe harbors, retention of overly complex state sales tax regimes, and changing of tax rules via administrative fiat rather than legislation.

NTUF is working with stakeholders and states to improve taxpayer protections in state sales tax laws. Meaningful simplification and steps towards interstate uniformity must accompany expansive sales tax authority.

Unfortunately, expanded state tax authority without promised simplification is playing out again with business taxes. Income taxes have been shielded from out-of-state taxation by the aforementioned P.L. 86-272 since 1959, but the MTC cites *Wayfair*, which only applies to sales tax, as an important factor in emboldening them to attempt a renewed push against P.L. 86-272.

P.L. 86-272 prevents states from assessing income tax liability on businesses with no physical presence in the state outside of solicitation of sales of tangible goods or activities directly ancillary to this goal. This meant that business activities such as distributing a mail-order catalog in a state, even if distributed by a salesperson, could not constitute taxable nexus assuming the business in question did not also maintain an in-state warehouse, for example.

The law was quickly enacted in 1959 to reverse a U.S. Supreme Court decision, *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450 (1959), which allowed states to tax out-of-state companies who employed salespeople in the state but had no other activity. P.L. 86-272 is sometimes described as temporary, as it envisioned an imminent overarching federal framework – still yet to be enacted as of 2022 – on state taxation of interstate commerce to prevent multiple taxation and excessive burdens.

Though P.L. 86-272 predates the advent of the internet by a few decades, it makes sense for its protections to apply to e-retail as well. After all, e-retail businesses follow the same model as mail-order businesses, just using more efficient and convenient technology to accomplish the same goal.

Nevertheless, the push to bypass P.L. 86-272 has begun in earnest. In mid-2021, the MTC released a statement that concluded that any number of common e-retail activities should lose a business the protections of P.L. 86-272. That list includes a business offering post-sale customer service, extended warranty plans, or job applications through its website.

This interpretation was taken up within months by California's Franchise Tax Board (FTB). In February of this year, the FTB released a tax guidance which largely copied the MTC's statement, though with the addition of tax implications for businesses with remote employees in California.

NTUF [covered the tax implications and interstate commerce implications of the MTC and FTB's announcements in more depth in a past paper](), but the influence of the *Wayfair* decision is worth diving deeper into. Both the MTC statement and FTB guidance lean on the same quote from the *Wayfair* decision: that "a business may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term."

As this analysis will establish, to say that the *Wayfair* decision gives, even in spirit, license to render P.L. 86-272 effectively obsolete requires a myopic focus on this single quote from the decision. Fundamentally, states are wrong to believe that *Wayfair* offers them a blank check to expand their tax authority wherever they wish.

Context of the *Wayfair* Decision

The first major problem with this conclusion is that the context of *Wayfair* was drastically different from prospective challenges to the traditional interpretation of P.L. 86-272. For one thing, overruling *Quill* required reinterpreting past judicial precedent, not judicially rendering federal law impotent.

While judges are often disinclined to overturn *stare decisis*, it is hardly unheard of. Overturning judicial precedent on sales tax nexus required only that the Supreme Court find that the past Court decisions on the matter had been wrongly decided and in need of updating.

Reinterpreting established federal law is another matter. While the Court certainly is capable of declaring federal law unconstitutional, that is not what California and the MTC are attempting to do here. Rather, should California's guidance go before a court, that court would be tasked with determining whether enforcement of business income taxes on out-of-state businesses with no physical presence in-state violates P.L. 86-272.

Below is the relevant text from P.L. 86-272:

> No state ... shall have power to impose ... a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
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> > (I) the solicitation of orders by such person, or his representative, in such State for sales 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.

The text then goes on to clarify that the protections of P.L. 86-272 do not apply to businesses incorporated in that state or residents of the state.

The text of P.L. 86-272 gives little reason to interpret various arbitrarily picked e-retail activities as incurring taxable nexus. In general, the test should be whether the same activity, conducted without the use of the internet, would lose a business the protection of P.L. 86-272. Consider some examples that California claims would incur taxable nexus despite P.L. 86-272:

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

- Posting open job descriptions and enabling viewers to apply through the website.

Activities with a similar level of connection to a state conducted over the phone do not, by and large, incur taxable nexus. For instance, the vast majority of states do not assess tax liabilities on out-of-state businesses for making sales by means of an 800 phone number, listing a phone number in local telephone books, or

even maintaining a phone number with a local area code. Meanwhile, in many states even recruitment activities held in-state such as job fairs do not incur taxable nexus so long as the position being recruited for is based out-of-state.

Other activities described under the FTB and MTC guidance, while not protected by P.L. 86-272, should be. The FTB and MTC claim to wish to reinterpret P.L. 86-272 to account for more modern technology, but at the same time appear to have no desire to update the law's protections for new types of goods and services. It is illogical, for example, to argue that digital goods and services and "cookies" that track user data are simultaneously intangible *and* constitute physical presence.

At the same time, another major contextual difference should be taken into account. A primary motivation behind the Court's willingness to overturn *Quill* was the perception that the existence of the physical presence standard for sales taxes created an unfair playing field for remote businesses, allowing them to avoid taxes. While e-retail customers were expected to collect and remit sales taxes on remote sales, customers generally ignored or were unaware of this. As a result, the *Wayfair* majority decried the *Quill* standard for "serv[ing] as a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State's consumers."

There exists no similar tax preference for remote businesses with income taxes. Many states already have so-called "throwback" or "throwout" rules, whereby "nowhere" income in states that lack the jurisdictional authority to tax it is accounted for in the tax liability calculation of states that do. And of course, states can choose not to tax business income through exemptions, credits, or not having a business income tax at all. In other words, the tools already exist for states to ensure that remote businesses do not face lower tax obligations than brick-and-mortar businesses.

The Results of *Wayfair* Are Now Clear

On the other hand, courts now have far more information about the compliance burdens of economic nexus tax enforcement than they did prior to *Wayfair*. Much of the underlying reasoning behind the *Wayfair* decision has since been proven to be based upon faulty and inaccurate assumptions.

While the Court considered the impact that economic nexus taxation could have on small businesses, it largely handwaved the issue. For instance, the Court has this to say regarding impacts on small businesses:

> Eventually, software that is available at a reasonable cost may make it easier for small businesses to cope with these problems. Indeed, as the physical presence rule no longer controls, those systems may well become available in a short period of time, either from private providers or from state taxing agencies themselves. And in all events, Congress may legislate to address these problems if it deems it necessary and fit to do so.
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> In this case, however, South Dakota affords small merchants a reasonable degree of protection. The law at issue requires a merchant to collect the tax only if it does a considerable amount of business in the State; the law is not retroactive; and South Dakota is a party to the Streamlined Sales and Use Tax Agreement.

That rosy picture has since been proven to be overly optimistic. While software for state sales tax filing does indeed exist, it by no means makes compliance a non-issue. As one business owner testified for the Senate Committee on Small Business and Entrepreneurship, the cost to use such software increases substantially for "additional" services such as filing in multiple jurisdictions or remittance of tax collections.

Perhaps even more significantly, even where state sales tax compliance software exists and can be purchased for a reasonable cost, it must also be integrated into a business's operations. Updating financial systems to work with new compliance software entails significant upfront burdens.

The second quoted paragraph likewise oversells states' willingness to limit compliance burdens. For one thing, while $100,000 in sales or 200 transactions with customers in-state may have been a reasonable safe harbor for selling into South Dakota, South Dakota is the 46th largest state by population and GDP. Many large states, such as New Jersey, Pennsylvania, and Florida, simply copied the exact same thresholds used by South Dakota. Others increased the threshold above $100,000, but less than would be proportionate. One state, Kansas, even went about two years before instituting any safe harbor at all.

While states did not attempt retroactive tax collection on the kind of grand scale that may have been feared, cases of "backdoor retroactivity" nevertheless occurred. California, for example, demanded sales taxes going back to 2012 from businesses using Amazon's Fulfilled By Amazon service.

Lastly, states have not interpreted *Wayfair* to mean that membership in the Streamlined Sales and Use Tax Agreement (SSUTA) is a prerequisite for economic nexus taxation. The SSUTA, which promotes standardization of tax definitions, simplified exemptions, state-level tax administration, and assistance with compliance costs, does not completely eliminate compliance burdens, but nevertheless ameliorates some of the greatest difficulties of multi-state tax filing. Unfortunately, no new states have joined SSUTA since the *Wayfair* decision in 2018, while "problem" states like Louisiana continue to enforce economic nexus tax rules despite ongoing litigation.

Conclusion

States flush with victory in the sales tax space may believe that, with *Wayfair*, they have won a license to do as they please. They are incorrect.

Should states like California continue to move forward with further expansions to their tax jurisdiction, courts must step in. *Wayfair* by no means provides the judicial justification to subject businesses and consumers to endlessly more complex and expansive tax nets.

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