Is P.L. 86-272 Unconstitutional?

by Brian Strahle

Brian Strahle

The SALT Effect is written by Brian Strahle, owner of Leverage SALT LLC. He does state tax research and writes for businesses and is the author of the state tax blog Leverage SALT (www.leveragestateandlocaltax.com). He welcomes comments at strahle@leveragesalt.com.

In this article, Strahle questions whether P.L. 86-272 is unconstitutional or discriminatory against companies that sell services or intangibles.

P.L. 86-272, passed in 1959, prohibits states from taxing the income of businesses that limit their in-state activities to the solicitation of orders for the sale of tangible personal property, so long as those orders are sent outside the state for acceptance and, if accepted, are fulfilled by shipment or delivery from outside the state. The law has protected out-of-state businesses from state income taxes for decades, but it has also provided much controversy.

Most of the controversy has been focused on what qualifies as solicitation or on what activities could be considered de minimis and not exceeding the protections provided by P.L. 86-272. Other areas of dispute have involved whether the law and its protections apply to activities by independent contractors or to types of taxes, such as franchise or gross receipts taxes. However, P.L. 86-272 has not been challenged on the grounds that it does not apply to companies that sell services or intangibles. Regardless of whether that exclusion was intentional or simply an oversight, when comparing business examples side by side, the unequal protection may be unconstitutional.

> Example 1: Company A manufactures widgets in state X. A sells widgets to customers in states Y and Z by sending salespeople into those states to make the sales (assume the salesperson's activities meet all the requirements of P.L. 86-272). Even if A exceeds economic nexus thresholds or factor presence nexus thresholds in Y and Z, it will be protected from nexus in those states under P.L. 86-272.
>
> Example 2: Company B licenses computer software to customers via the cloud. B's physical offices and servers reside in state X. B solicits sales from customers in states Y and Z via telephone and Internet and does not physically enter Y or Z to solicit sales or perform any services. If services are provided, all services are performed in state X. Because B sells intangibles or services, P.L. 86-272 does not apply. Thus, if B's sales exceed economic nexus or factor presence thresholds for Y or Z, B could be held to have income tax nexus there.[1]

If you're a business owner or nontax professional, those different results make no sense and seem unfair. B has less contact with Y or Z and could still have income tax nexus, while A escapes income taxation.

> **By failing to require an update of P.L. 86-272, states can tax the growing part of our economy while protecting manufacturers and retailers.**

The Marketplace Fairness Act of 2013 (S. 743) attempts to level the playing field between brick-and-mortar retailers and remote retailers for sales tax purposes; Congress and the states should seek to level the field between sellers of tangible personal property and sellers of services or intangibles for income tax purposes. All types of businesses (manufacturers, retailers, service providers, cloud computing) should be protected from income tax nexus when they meet the requirements of P.L. 86-272. By failing to require an update of P.L. 86-272, states can tax the growing part of our economy — services, electronically delivered software, cloud computing — while protecting manufacturers and retailers.

Background

P.L. 86-272 was enacted in response to concerns from businesses and Congress following *Northwestern Cement Co. v. Minnesota*, 358 U.S. 450 (1959). Northwestern Cement had an office in Minnesota and at least one salesperson there who actively solicited orders for company products. Those orders were accepted at, and filled from, the company's head office in Iowa. The U.S. Supreme Court concluded that net

---

[1] Some states treat canned software delivered electronically as tangible property and some treat it as intangible property. Some states treat both canned and custom software as intangible property, or treat all licenses of software as intangible property. As a result, determining whether the protections of P.L. 86-272 apply to sellers of software requires a state-by-state analysis.

income from the interstate operations of a foreign corporation may be taxed by a state as long as the tax is not discriminatory and is properly apportioned to local activities within the taxing state. In reaching its decision, the Court referred to *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435(1940), in which it said "the controlling question is whether the state has given anything for which it can ask return."

The decision resulted in congressional concern regarding how businesses would determine the type of activities in a state that would create nexus. The nonuniform rules among the states could cause situations in which the costs of compliance would outweigh the tax owed. Congress enacted P.L. 86-272 as a stop-gap measure to restrict a state from collecting income tax on sales solicited within its borders as long as the orders were filled or shipped outside the state.[2] That P.L. 86-272 doesn't protect services or intangibles may simply be an oversight caused by pressure from businesses and Congress to quickly mitigate fallout from *Northwestern Cement*.

> **Unfortunately, the measure that the 1959 Senate report noted was 'not a permanent solution to the problem' has become a permanent and outdated law.**

Unfortunately, the measure that the 1959 Senate report noted was "not a permanent solution to the problem" has become a permanent and outdated law. Tax practitioners and Congress have considered changing the law, but agreement cannot be reached on what revisions should be made. Federal legislation to modernize P.L. 86-272 has been proposed year after year without gaining enough traction for passage. The Business Activity Tax Simplification Act of 2013 (H.R. 2992), introduced in August 2013, sought to expand P.L. 86-272 to the sales of services and intangibles that are fulfilled or distributed from outside a state. Protected activities would include furnishing information, covering events, or other information gathering in the state when the information is used or disseminated from outside the state. The safe harbor for the in-state activities of independent contractors would be expanded to include those activities. The legislation never made it out of committee. Perhaps it would have passed if it hadn't proposed other changes, such as expanding P.L. 86-272 to business activity taxes and requiring an out-of-state entity to have a physical presence before being taxable in a state.

Equal Protection?

State courts and legislation have created a legally questionable and potentially hazardous concept of economic nexus by determining nexus based on a person's economic relationship to persons in a state, with physical presence being irrelevant.

The imposition of economic nexus must meet the standards in the due process and commerce clauses of the U.S. Constitution. The due process clause imposes two restrictions on a state's power to tax income generated by the activities of an interstate business: No tax may be imposed unless there is some minimal connection between those activities, and the taxing state and the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state.

Due process nexus does not require an in-state presence. Sufficient contacts exist to create due process nexus if the business purposefully avails itself of the benefits of an economic market in the state. Thus, states often successfully argue that the imposition of economic nexus on a particular taxpayer meets the due process clause standard.

The commerce clause requires more stringent contacts with the state. Unlike the due process clause, the commerce clause is designed to protect interstate commerce from state taxes that unduly burden interstate transactions. The well-established four-part test in *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977), says the tax must:

- be applied to an activity with substantial nexus with the taxing state;
- be fairly apportioned;
- not discriminate against interstate commerce; and
- be fairly related to the services provided by the state.

The commerce clause nexus requirement addresses the structural concerns that may arise when each state has the power to levy state taxes on the same interstate activity, and thus imposes a greater limitation on state authority to tax. A long line of U.S. Supreme Court decisions has established that for commerce clause purposes, substantial nexus means physical presence.

Despite *Complete Auto*, some states have adopted more lenient definitions of substantial nexus that reflect economic nexus. For example, some states have defined substantial nexus as a taxpayer regularly taking advantage of the state's economy to produce income, saying nexus may be established through a taxpayer's significant economic presence in the state.[3] To determine whether substantial nexus exists, some states look at the regularity of contacts in the state, deliberateness of marketing to customers, and significant gross receipts from customers or from the use of intangible property in the state. Also relevant is whether the business is protected by the state's laws, has court access, uses state roads, benefits from the state's educated workforce, or receives police and fire protection for property in the state that displays a taxpayer's intellectual or intangible property.

When states successfully argue that economic nexus standards meet due process and commerce clause standards, companies not protected by P.L. 86-272 that sell services or intangibles are held to have nexus. Sellers of tangible personal

[2]S. Rep. No. 658 (1959).

[3]Oregon Department of Revenue adopted rule OAR 151-317.010.

property can claim protection under P.L. 86-272. Thus, sellers of services or intangibles may want to consider whether discrimination can be claimed under the equal protection clause of the 14th Amendment of the U.S. Constitution. That clause prohibits states from denying any person within its jurisdiction the equal protection of the laws. Out-of-state sellers of services or intangibles are in the same — if not better — position than out-of-state sellers of tangible personal property. The only difference is the type of product being sold into the state. Should a state's ability to impose an income tax hinge on the type of product being sold?

The 14th Amendment is not by its terms applicable to the federal government; thus, it could be argued that it doesn't apply to P.L. 86-272. However, actions by the federal government that classify individuals in a discriminatory manner may, under similar circumstances, violate the due process clause of the Fifth Amendment. Could P.L. 86-272 be held to be discriminatory (or unconstitutional) against companies that sell services or intangibles? ✰