

# Business tax nexus & the attack on P.L. 86-272

Ohio Business Tax Seminar

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# Speakers

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# Agenda

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1. Economic nexus post-*Wayfair*
2. P.L. 86-272 developments
3. Taxpayer response



# Economic nexus post-*Wayfair*

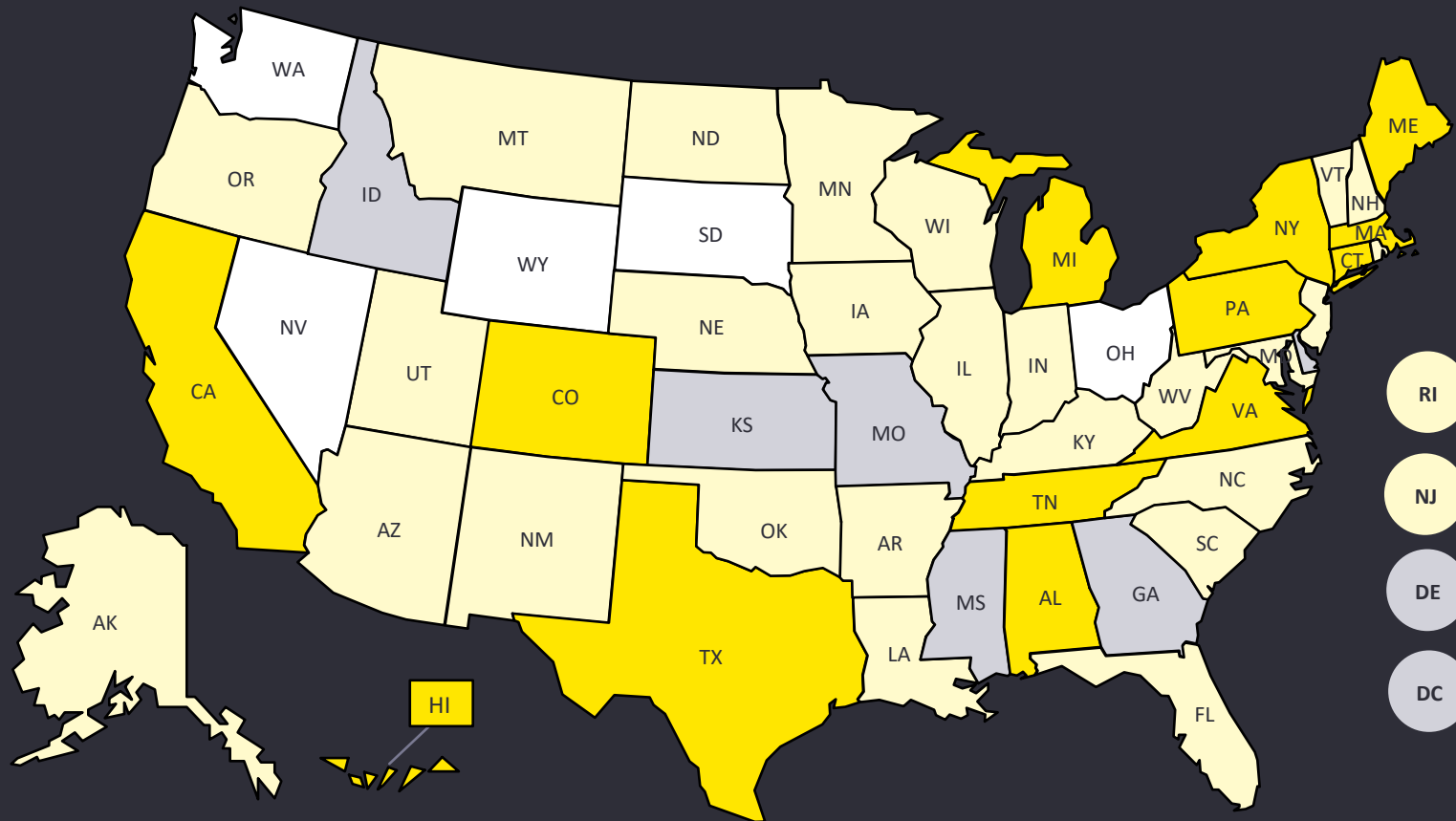
Sales  
delivery

“

[A] business may be present in a State in a meaningful way without" that presence "being physical in the traditional sense of the term.

*South Dakota v. Wayfair, Inc.*, 585 US \_\_\_\_; 138 S. Ct. 2080 (2018)

# Economic nexus for state corporate income tax purposes



**Key:**

- Economic nexus with bright-line\* test
- Economic nexus with no bright-line test
- No guidance or authority to suggest economic nexus standard
- No corporate income tax

For purposes of this map, whether the state asserts economic nexus is based on statutes, regulations, administrative pronouncements, and decisions (i.e., rulings from state supreme courts, state appeals court, state circuit and district level courts, tax appeal board opinions and administrative level decisions).

\* Bright-line test in this context refers to the use of a defined threshold of in-state sales or receipts to assert nexus for state corporate income tax purposes.

Source: Ernst & Young LLP analysis as of April 4, 2022.

# Factor presence economic nexus standard


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- An increasing number of states employ bright-line thresholds for income tax nexus.
  - Most recent are 2021 Maine LD 1216 (Chapter 181) and 2022 Pennsylvania HB 1342 (Act 53).
- Several states adopt the following factor presence-based thresholds:
  - \$50,000 of property; or
  - \$50,000 of payroll; or
  - \$500,000 of sales; or
  - 25% of total property, payroll or sales.

} Physical presence thresholds

} Economic presence threshold
- Reliance on state apportionment rules, which differ significantly, presents problems in implementing a bright-line economic nexus thresholds.
  - See, e.g., *Greenscapes Home and Garden Products, Inc. v. Testa*, 2019-Ohio-384, 129 N.E.3d 1060 (App. 10th Dist 2019).





# P.L. 86-272 developments

# Restriction on state taxing authority

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- Public Law (P.L.) 86-272:
  - In Title I, Section 101, prohibits the imposition of state and local income tax on a certain corporations.
    - The law was designed to protect out-of-state corporations when the corporation's only in-state activity was the solicitation of sales and ancillary activities.
    - This protection only applies to state income taxes.
  - In Title II, Section 201, commissioned a congressional study of state taxation of interstate commerce.
    - That study, known as the Willis Report, indicated that P.L. 86-272 should be replaced with a more quantitative rule based in part on the volume of business done in a state.
    - The committee's activities and recommendations led to the eventual formation of the Multistate Tax Commission (MTC).

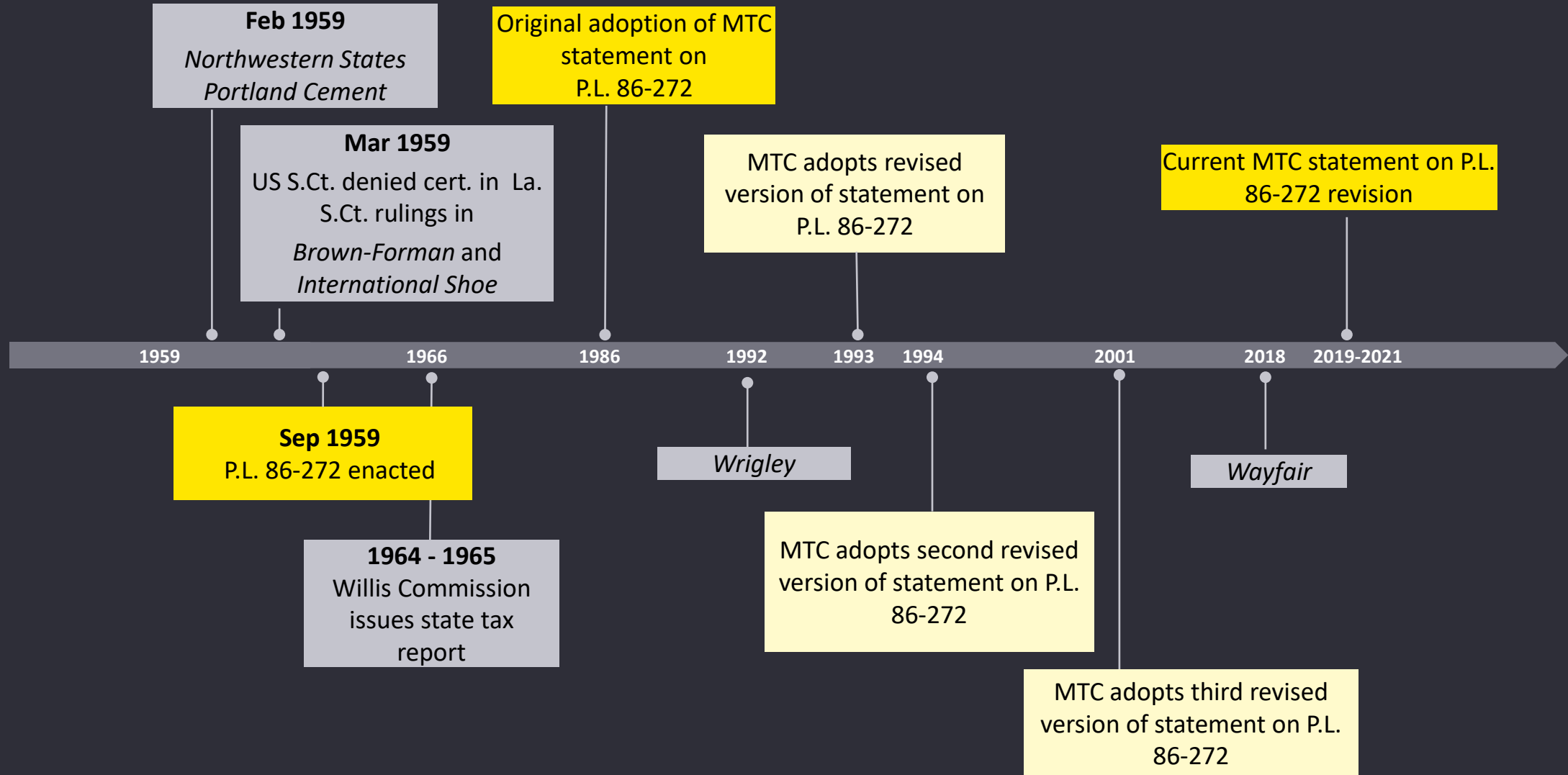
“

No State, or political subdivision thereof, 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 [...]:

(1) 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; [...]

15 US Code § 381(a)(1)

# P.L. 86-272 timeline of key events



## Revised MTC “statement of information” on P.L. 86-272

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- In its fourth revision of its statement of policies on implementing P.L. 86-272, adopted August 4, 2021, the MTC added a new section on unprotected (and protected) activities: “Activities conducted via the internet.”
  - Although *Wayfair* did not interpret P.L. 86-272, the revised statement references the case:
    - “[T]he Supporting States consider the Court’s analysis as to virtual contacts to be relevant to the question of whether a seller is engaged in business activities in states where its customers are located for purposes of the statute.”
    - Per the revised statement, “As a general rule, when a business interacts with a customer via the business’s website or app, the business engages in a business activity within the customer’s state.”
- States (including non-member states) are free to adopt or otherwise **expressly indicate** support for the MTC’s statement by legislation, regulation, or other administrative action.

## Select examples of **protected** activities

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- The business provides post-sale assistance to in-state customers by posting a static list of FAQs with answers on the business's website.
- The business places Internet "cookies" onto the computers or other devices of in-state customers to gather customer information only used for purposes entirely ancillary to the solicitation of orders for tangible personal property, such as:
  - to remember items customers have placed in shopping carts 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.
- The business offers for sale only items of tangible personal property on its website where that website enables customers to:
  - search for items,
  - read product descriptions,
  - select items for purchase,
  - choose among delivery options, and
  - pay for the items.

## Select examples of **unprotected** activities

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- The business regularly provides post-sale assistance to in-state customers via either electronic chat or email that customers initiate by clicking on an icon on the business's website.
- The business's website invites viewers in a customer's state to apply for, and accepts applications for, non-sales positions with the business.
- The business places Internet "cookies" onto the computers or other electronic devices of in-state customers. These cookies gather customer search information which will be used to adjust production schedule and inventory amounts, develop new products, or identify new items to offer for sale.
- The business remotely fixes or upgrades products previously purchased by in-state customers from the business by transmitting code or other electronic instructions to those products via the Internet.
- The business contracts with in-state customers to stream videos and music to electronic devices for a charge.

## State responses to MTC Statement on P.L. 86-272: California

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- In Technical Advice Memorandum 2022-01 (TAM 2022-01) (issued February 14, 2022), the California Franchise Tax Board (FTB) advised on applying P.L. 86-272 to “fact patterns that are common in the current economy due to technological advancements ... “ (i.e., activities conducted over the internet and telecommuting).
  - The FTB’s positions on protected and nonprotected internet activities largely follow those expressed in the MTC Statement without specifically adopting or referencing the Statement.
  - TAM 2022-01 does not provide an effective date and could be applied retroactively.
- On August 19, 2022, the American Catalog Mailers Association filed a complaint for declaratory and injunctive relief against the California FTB, seeking to have TAM 2022-01 and related publication, FTB 1050 “Application and Interpretation of P.L. 86-272” (FTB 1050), declared invalid.
  - The complaint asserts that the guidance was issued without following the rulemaking procedures required by the state’s Administrative Procedure Act, and that it is “in direct contravention of P.L. 86-272 and the US Constitution.” *American Catalog Mailers v. Franchise Tax Board*, Compliant filed Cal. Superior Ct., San Francisco Cnty., Aug. 19, 2022.



# State responses to MTC Statement on P.L. 86-272: **New York**

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- The New York Department of Taxation and Finance (NY DOTF) released updates to Parts 1 through 3 of the Article 9-A Business Corporation Franchise Tax draft regulations (draft regulations) (updated August 2022) identifying which activities conducted over the internet would be protected by P.L. 86-272.
  - The NY DOTF's positions on protected and nonprotected internet activities largely follow those expressed in the MTC Statement, and the NY DOTF acknowledges such.
  - The draft regulations do not provide an effective date and could be applied retroactively.



## State responses to MTC Statement on P.L. 86-272: Oregon

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- The Oregon Department of Revenue (OR DOR) on August 23, 2022 held virtual Rules Advisory Committee (RAC) meeting to address whether the OR DOR should adopt the MTC Statement and apply it to all periods open to examination.
  - The OR DOR acknowledged the RAC and public's unanimous opposition to the MTC statement and indicated the OR DOR will consider:
    - Applying the MTC Statement on a prospective basis
    - Creating a bright-line, factor-presence nexus threshold above which businesses would be subject to state income tax
    - Consulting the Oregon legislature
- Subsequently, in its September 20, 2022 meeting, the OR DOR announced it will not adopt the MTC Statement at this time.
  - The OR DOR noted the issue is more complicated than simply adopting the MTC Statement.
  - The OR DOR may resume the project after Oregon's 2023 legislative session.



## Developments to watch

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- Representatives of the **New Jersey** Division of Taxation have announced forthcoming draft regulations that incorporate guidance on internet activities, similar to the MTC Statement.
- On April 25, 2023, the **Minnesota** Department of Revenue circulated a draft notice to stakeholders stating that it “will adopt and apply the MTC guidance on the scope of internet business activities...”

# Developments to watch

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- On August 22, 2022, the **MTC** Uniformity Committee’s partnership taxation work group published a revised outline of partnership issues falling within the scope of its project to include new Section 2.1.4, Application of P.L. 86-272 to Partnership Income.
  - The outline cites questions as to how “transferrable” the unprotected activities of a partner may be to/from a partnership (and vice versa) – describing these issues as being unanswered by the courts. Included examples are:
    - “[I]f the partnership has a corporate partner which is domiciled or conducting activities generally unrelated to the partnership’s business in a state, does this mean the partnership may lose the protections of P.L. 86-272?”
    - “Does the fact that an individual limited, passive partner is resident in the state mean that the partnership loses the protections of P.L. 86-272? What if that partner owns a majority interest in the partnership?”
    - “Does the fact that a partnership does business in the state mean that its corporate partner loses protection for that corporate partner’s separate business which would otherwise be protected?”



# Taxpayer response

# The reach of physical presence nexus

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- State and local statutes or regulations may exempt certain in-state activity, such as:
  - Delaware statutory office exemption (Del. Code Ann. § 1902(b)(6))
  - City of Detroit exemption for “Maintenance, by a corporation, of a resident agent in the city” (Regulation 5.1) (See *Apex Laboratories International Inc. v. City of Detroit*, MOAHR Docket No. 16-000724-R (August 18, 2022))
- Bright-line factor presence nexus standard generally creates a de minimis rule.
  - Typically, the threshold is \$50,000 of in-state property and/or payroll or 25% of total property and/or payroll everywhere.
  - The determination of in-state amounts is based on apportionment factor rules, which vary across jurisdictions.

# The reach of physical presence nexus

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- The imposition of state taxes based on only a temporary physical presence may be invalid under the US Constitution.
  - The continuous and systematic presence of in-state employees is a sufficient basis for a jurisdiction to impose tax on out-of-state business. *International Shoe Co. v. Washington*, 326 US 310 (1945) [under a Due Process analysis].
- However, courts and tax administrators have noted circumstances in which a temporary employee presence in the state is insufficient in number or nature as to subject a business to tax.
  - The US Supreme Court declined to agree with the California Supreme Court's conclusion that "slightest presence" in the state permitted the state to impose on the seller the duty of collecting use tax. (Nevertheless, the seller's continuous presence was sufficient nexus to justify the collection of use tax.) *National Geographic Society v. State Board of Equalization*, 430 US 551 (1977).

# Due Process Clause challenges

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- “Due process centrally concerns the fundamental fairness of governmental activity. Thus, at the most general level, the due process nexus analysis requires that we ask whether an individual’s connections with a State are substantial enough to legitimate the State’s exercise of power over him.” *Quill Corp. v. North Dakota*, 504 US 298 (1992).
- Necessary contacts with the forum state:
  - Due Process requires that person must have “purposefully avail[ed] itself of the privilege of conducting activities within the forum State.” The contacts must be the defendant’s own choice and not “random, isolated, or fortuitous.” *Ford Motor Co. v. Montana Eighth Judicial District Court*, 141 S. Ct. 1017, 1025 (2021).
  - Recently, the Louisiana Court of Appeals found that contacts with the state initiated by the activities of third parties were not sufficient to establish personal jurisdiction over the supposed taxpayer. Also, because there was no intentional or direct contact by the supposed taxpayer, there is no reason for it to have reasonably anticipated being brought into court in Louisiana. *Robinson v. Jeopardy Productions Inc.*, 2019 CA 1095 (La. Ct. App. 1st Cir. 2020), writ denied, 308 So. 3d 1166 (2021).



# Strategies available to taxpayers

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- Voluntary disclosure agreements
- Amnesty programs
- Pre-filing agreements
- Tax policy/advocacy
- Litigation



A photograph of a warehouse worker sitting at a computer workstation. The worker is wearing a dark vest over a purple long-sleeved shirt. They are looking at a computer monitor which displays a light blue screen. The workstation is cluttered with stacks of papers and a keyboard. In the background, there is a conveyor belt with several cardboard boxes. The warehouse has high ceilings with yellow structural beams and various equipment. The overall lighting is somewhat dim, typical of an industrial setting.

Thank you for participating.

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Jim Cochran is a Senior Tax Counsel at Sherwin-Williams. In this role, Jim handles a wide variety of federal, state, and local tax matters for the company, including credits and incentives and operational planning, and IRS and state income tax audit support and controversy. Prior to joining Sherwin-Williams in 2020, Jim spent 8 years practicing international tax at PwC, including a 2-year tour in PwC's Washington National Tax Services practice. Jim earned his B.S. in Accounting from the University of Akron and his J.D. from Cleveland State University College of Law.



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Bill works in EY's National Tax Department and is based in the Akron, Ohio office. Bill serves several Northeast Ohio clients as an Indirect Tax Service Line Leader. Bill is also a part of EY's State Desk network. Bill is the firm's Ohio Desk for income and sales/use taxes and is also serves as income tax desk for several states. In this role, Bill works with EY engagement teams and their clients on matters such as audit defense and controversy resolution, refund reviews, and rendering day-to-day state tax advice.

Bill is a member of the Ohio State Bar Association, Ohio Society of CPAs, Kentucky Society of CPAs, Wisconsin Society of CPAs, and Iowa Taxpayer Association. HE serves on the tax committees for many of these organizations and has participated in working groups to assist policymakers in drafting administrative rules and other taxpayer guidance. Most recently Bill served on a joint task force with the Wisconsin Society of CPAs and Wisconsin Department of Revenue to develop pass-through entity audit legislation.

Bill frequently speaks on state and local tax topics at national and regional conferences. He has had articles published in the Journal of Multistate Taxation and the ABA Tax Lawyer.

Bill also serves as Treasurer and a member of the Board of Trustees for the Akron Symphony Orchestra and on the Dean's Advancement Council for the University of Akron College of Business Administration.

Bill received his BBA (Accounting) at Cleveland State University in 1993 and is a Certified Public Accountant. Bill received his JD from Case Western Reserve University School of Law and was admitted to the Ohio Bar in 1996.

# Biography



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### Profile and experience

- Jess Morgan is a Senior Manager in the EY National Tax Department, specializing in US state and local taxation.
- With respect to corporate income taxes, Jess helps businesses plan for tax and accounting impacts of strategic transactions, particularly those impacting multinational enterprises.
- Jess also partners with the EY US State Policy Services team, advising businesses and government organizations on the US sub-national tax response to global economic developments. She is a frequent speaker and writer on the state tax implications of international tax reform proposals of the digital economy.

### Education, certifications and local involvement

- Jess is a graduate of the College of William and Mary, where she studied business and religion, and she earned a master's degree in accounting at the University of Central Florida.
- An Ohio CPA, Jess currently serves on the Ohio Society of CPAs State and Local Tax Committee. She is an officer of the Tax Club of Cleveland.

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