How P.L. 86-272 Protections Play Out in the Post-Wayfair Environment

By Stacey Roberts*

Stacey Roberts discusses how the Wayfair decision has blurred the lines between sales tax and income tax nexus.

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The line where income tax and sales tax obligations meet became more blurred by *Wayfair*. As nexus around these two tax regimes gets redefined and redeployed state-by-state, determining whether P.L. 86-272 protections apply is both confusing and complex. Adding to the confusion are a host of additional factors that influence whether P.L. 86-272 applies, requiring businesses and tax preparers to dig in, understand the history, and consider evolving rules state-by-state before relying on P.L. 86-272 protections. Sales tax registration can beget income tax filing, and as time goes on, these two concepts are becoming more closely related. How we've gotten to this point in state and local tax is both interesting and fluid, and necessary to understand before a taxpayer or preparer can determine whether and where P.L. 86-272 protections apply.

P.L. 86-272 is a federal law enacted in 1959 to minimize the income tax burden of multistate operations. As a federal law, P.L. 86-272 supersedes state law and prohibits states from imposing net income-based taxes in limited situations. Specifically, out-of-state taxpayers are protected when their activities in a state are limited to the solicitation of sales of tangible personal property, the orders of which are approved and shipped from outside the state.

This law was enacted in a time when the way we transacted business was either face-to-face or door-to-door. In the movie *The Founder*, McDonald's visionary Ray Kroc, portrayed by Michael Keaton, drives around the country during the 1950s selling milkshake machines. *The Founder* is a good example of how the transitory nature of product sales outside a retail store used to work—bring the product to the potential customer, demonstrate the product, and hopefully, sell it out of the back of your car. However, if Kroc did not sell the machines from his trunk, but instead simply solicited orders for them, and sent those orders outside of the state for acceptance and fulfillment, he would not have an income tax filing obligation in the state. He would have a sales tax filing obligation, but absent any office, warehouse, or other physical location, his solicitation alone would not trigger an income tax filing obligation.

Since the 1950s, the way we transact business has changed dramatically. Amazon—and other web sellers have created searchable and interactive, anywhere, anytime retail websites, with video and chat boxes that eliminate the need to meet or call a salesperson. Yet, P.L. 86-272 has changed very little in the intervening years, creating complexity and confusion over what taxes are due and where. Potential movement, however, may be on the horizon.

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In planning for compliance, there are three steps to determining whether P.L. 86-272 protections apply to a taxpayer:

1. Determine whether a taxpayer has a connection, or nexus, to the state or local jurisdiction that creates a potential filing obligation.
2. Assess whether the sale is sourced to the state using an apportionment formula.
3. Identify protected activities per P.L. 86-272 and determine tax liability.

The remainder of this article takes a close look at each step to help taxpayers and preparers determine when and where P.L. 86-272 applies.

Defining Nexus

Nexus standards for income tax and sales tax were once both focused on physical presence. If you have a company with employees or agents based in, traveling to, or working remotely in the state, absent the protection of P.L. 86-272, the employee's physical presence alone generally triggers nexus for both income and sales tax. If a business or individual owns or leases property in a state, this creates nexus for the lessor and lessee. Inventory located in a third-party warehouse, such as an FBA Amazon warehouse, also triggers nexus for income and sales tax.

Economic nexus in income tax dates to the early 1990s, when South Carolina claimed that Geoffrey, the mascot for the toy distributor Toys "R" Us, had a filing obligation with the state. The trademark giraffe, "Geoffrey," was a Delaware holding company that licensed the intangible asset to Toys "R" Us stores throughout the United States. This common tax strategy generated income in a state that would not be taxed, and an expense in states where the income would not be recognized, thereby shifting income away from separate company reporting states.

The state of South Carolina sought to tax the out-of-state holding company for licensing Geoffrey in its state, despite no "physical presence" of the intangible asset. South Carolina won, prompting other states to start using "economic nexus" as a trigger to require companies to file and pay taxes.

Geoffrey gave rise to broadly defined nexus standards. Holding companies that were licensing intangible assets into a state now had a filing obligation in those jurisdictions. Then states began to target financial institutions generating income from credit cards or loans claiming their use in a state was economic nexus thereby prompting a duty to pay taxes.

In the years since *Geoffrey*, economic nexus in income tax has further evolved. In some states, economic nexus is determined by the ability for a company to profit, whether by one dollar or a hundred thousand plus, from maintaining a market and directing their marketing activities into a state. By design, the amount of income for determining economic nexus is unclear.

More recently, 12 states have expanded their definitions for "doing business" within a state by tying it to the dollar values of property, payroll and sales in the state. For example, if a business has $500,000 in sales, or $50,000 in property or payroll in the state, it has economic nexus in the state. We term these "factor presence" states.

While this income tax history directly applies to P.L. 86-272, evolving economic nexus requirements in sales and use tax *indirectly* impact P.L. 86-272 by increasing the number of filers that could benefit from the protections under P.L. 86-272. In June 2018, the seminal U.S. Supreme Court case of *Wayfair Inc. v. South Dakota* (*Wayfair*)[1] ushered in new economic presence definitions for sales and use tax that coexist with physical presence standards.

Economic nexus for sales and use tax is triggered when thresholds tied to dollar or transaction activity in a state or local jurisdiction are exceeded. Since *Wayfair*, 44 states and the District of Columbia have adopted economic nexus thresholds. Only two states that impose sales tax, Florida and Missouri, at the time of this writing, have not yet added economic nexus thresholds for sales taxes (Alaska, Delaware, Montana, New Hampshire and Oregon do not have a state-based sales tax).

Many more multijurisdictional taxpayers now have sales tax nexus in multiple locations, requiring them to register in each one. With each registration, taxing authorities are put on notice that a taxpayer is "doing business" and active in the state, which can lead to additional tax requirements. Any taxpayer exceeding the magic nexus threshold in a state is deriving income from that state and may have additional income, franchise, business and occupation (B&O), gross receipts and other tax filing obligations.

Notice and reporting requirements similarly put the spotlight on taxpayers doing business in a state. Under these requirements, taxpayers in various states such as Colorado, Oklahoma and Texas that didn't collect sales tax from transactions into the state were required to report those transactions and related buyers to the state. While most states have removed or modified notice and reporting requirements, the damage has been done; taxpayers, who did the right thing in the right place, were identified as deriving income in those states and flagged for potential income and other tax duties.

While the South Dakota sales threshold in Wayfair was either $100,000 in sales or 200 separate sales transactions, some states have dispensed with the transaction test. Among those, California, Colorado and Washington removed transaction counts from their nexus thresholds. Arizona, Idaho, and New Mexico adopted economic nexus laws that do not include a transaction threshold. The absence of a transaction count leaves only the bright-line dollar amount that clearly indicates a taxpayer is doing business in the state.

Factor-Presence Test

Taxpayers that exceed a "factor-presence" test in some states will also trigger income tax nexus. Of these states, only a few of them follow the Multistate Tax Commission (MTC) *factor-presence test* for income, franchise, and gross receipts tax. The MTC, an intergovernmental state tax agency, initially promulgated the factor presence test of $50,000 in property in the state, or $50,000 in payroll, $500,000 in sales, or 25% of the taxpayer's total property, total payroll or sales in the state. If the thresholds are met, the seller has economic nexus in the jurisdiction.

Not every state with factor-presence follows MTC guidelines, and states that do pick and choose what standard they will follow. Some examples of the disparity among states imposing a factor-presence test include:

- Alabama (2015): follows MTC rule closely;
- California (2011): follows MTC rule with threshold adjusted for inflation;
- Connecticut (2010): follows MTC rule and is a single sales factor state;
- Colorado (2010): bright line and factor-presence test of $500,000, consistent with MTC;
- Michigan (2012): $350,000 sales threshold and does not follow MTC rule;
- New York (2015): $1,000,000 sales threshold and does not follow MTC rule;
- Ohio: follows MTC rule for the CAT only;
- Oregon (2020): gross receipts tax based on threshold; does not have general sales tax but taxes some transactions like sales tax;
- Pennsylvania (2020): follows MTC $500,000 sales rule;
- Tennessee (2016): follows MTC $500,000 sales rule;
- Texas (2020): follows MTC $500,000 sales rule;
- Virginia: if have positive apportionment factor, you are subject to income tax; and
- Washington (2010): Washington has B&O tax based on business seller classification, but has a bright-line test for service providers, wholesalers and retailers.

Sourcing Income to a State

After establishing nexus, a taxpayer must determine whether income is sourced to a state and included in the sales factor of the state's apportionment formula. Do the sales shipped into a jurisdiction get included in the sales factor of the destination state?

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The answer to this question is critical in determining whether a taxpayer (1) has nexus in those states that impose a factor presence test and (2) has a tax liability in states where the taxpayer otherwise has nexus (due to physical presence). If a taxpayer sells a good, the nexus creating activities of the taxpayer in the state needs to be examined; if the activities do not exceed P.L. 86-272, then the sale would not be sourced to the "ship to" or destination state for income tax purposes and the taxpayer would not be "doing business" because it would not meet the factor presence test. In addition, in those states where the taxpayer otherwise has nexus, those sales would not be included in the sales factor of the "ship to" state because the business's activity is protected again by P.L. 86-272.

Income is protected under P.L. 86-272 and the sales are not included in the sales factor of the destination state if:

- The only activities in the state are solicitation of sales, the orders of which are approved and shipped from outside the state; and
- Activities in the state are limited to soliciting sales of tangible personal property.

Throwback Rules

Throwback rules also impact nexus and the application of P.L. 86-272. States with throwback rules, such as Colorado, require taxpayers that ship goods from Colorado to a state in which that taxpayer does not have nexus to "throwback" the sales to the originating state, in this case, Colorado. If a taxpayer has sales that are shipped from Colorado and is protected under P.L. 86-272, then the taxpayer is not deemed to have the requisite nexus in the ship to state and those sales must be thrown back to Colorado to be included in the Colorado sales factor numerator.

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Not all states have a throwback rule, creating an opportunity for sales shipped from those jurisdictions to be considered "nowhere income." These are sales that are not sourced to and included in any jurisdiction's sales factor numerator, ship to or origination.

Separate and Combined Filing

Further complicating matters in the application of P.L. 86-272 is state income tax filing methods. Historically, only a few states required affiliated groups of entities to file on a mandatory unitary/combined method. Over the years, more and more states have shifted from separate company reporting to mandatory unitary/combined reporting. This required filing methodology, coupled with a state's throwback rule, can create complex sourcing issues for determining the sales factor for apportionment purposes in any particular jurisdiction, and it can become even more complicated when affiliates may or may not have P.L. 86-272 protection in a "ship to" state.

Joyce vs. Finnigan

Joyce and *Finnigan* introduced two apportionment approaches to consider for states with unitary/combined reporting regimes and throwback sales. These California cases decided years ago, forced combined reporting states like California, Colorado, Illinois, and Utah, to choose whether to follow the *Joyce* rule or the *Finnigan* rule.

Joyce provides that entities within a combined group treat nexus and throwback sales on a separate entity basis. For example, Colorado follows *Joyce.* If a Colorado-based taxpayer in a combined group ships goods from Colorado to states in which the Colorado taxpayer does not have nexus, the entity will not source those sales to those states. Instead, those sales are thrown back to Colorado and included in the Colorado sales factor numerator for that entity. However, if a sister company in the combined group has nexus in the same jurisdiction that sister company will not throw its sales back but source to the destination state for apportionment purposes. In short, whether sales are thrown back is determined on a separate company basis.

By contrast, *Finnigan* says if one entity in a combined group has nexus, they all have nexus for throwback sales. California started as a *Joyce* state, became a *Finnigan* state, then switched back to *Joyce*, and is now a *Finnigan* state again. Continuing with our example, if an entity in our Colorado combined group is protected under P.L. 86-272 from filing in California, but other entities in the group are not, the protected entity's sales will not be thrown back to Colorado, but included in the California sales factor for apportioning the income of the combined group members that do file in California. In short, the entity's sales will be included in both the Colorado numerator for its own return, and in the California numerator of the combined group members filing in California. A taxpayer could be filing a California return and sourcing sales a certain way and get a notice from California requiring that all sales from the combined entity into the state be sourced to the state. This can be a trap for the unwary. Here again, the implications of P.L. 86 272 complicate the matter and prudent tax preparers must carefully calculate their sales factor apportionment with *Joyce*, *Finnigan*, nexus, and P.L. 86-272 in mind.

Facts and Circumstance Based

We are seeing more and more of P.L. 86-272 as taxpayers register for sales tax post-*Wayfair*. Generally, the sale of a tangible item is taxable for sales tax purposes, but it may not create income sourced to a state for income tax purposes due to P.L. 86-272.

P.L. 86-272 only applies to sales of tangible personal property; any activities involving services, such as repairs, warranties, or training, are not protected by P.L. 86-272. From a protected activity perspective, your salespeople may carry samples and have an in-state home office, as long they are only soliciting sales. Any ancillary activities to the solicitation of sales are protected but any non-ancillary tasks could put the taxpayer into an unprotected situation, thereby losing its P.L. 86-272 protection. (The MTC has promulgated a list of what it deems to be protected and unprotected activities that can be found at *www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/StatementofInfoPublicLaw86-272.pdf*.)

The emphasis on ancillary activities means that taxpayers need to establish a collection of strong facts around the activities and operations of their salespeople to claim P.L. 86-272 protection. Companies must monitor closely what their salespeople are doing out in the field to make certain those activities are, and continue to be, protected. For example, the Maryland Tax Court recently held that the collection of competitive information by employees was not ancillary to solicitation, exceeded the protection provided by P.L. 86-272, thereby creating a filing obligation in the state[2]:

> Please note that many states deviate from the MTC's list of protected and unprotected activities, the items on the lists have changed over time, and that the onus is on the taxpayer to check state law and confirm protected activities. The MTC issued draft guidance on interactive websites in October 2019, yet to be finalized as this goes to print, that will further limited P.L. 86-272 protections and is worth monitoring.

As if state income tax compliance were not complex enough before, the *Wayfair* decision, economic nexus, factor presence standards, combined reporting, throwback differences, and P.L. 86-272 will continue to change at the state level unless federal lawmakers intervene. It is more likely that the states, confronted with the pandemic blow to their budgets will find more reasons to extend their nexus net and limit the protections of P.L. 86-272.

P.L. 86-272 only applies to income taxes. Its protection does not extend to sales and use, franchise, net-worth based taxes, such as in those seen in North Carolina, and other "privilege of doing business" taxes. Some of the state taxes that are not protected under P.L. 86-272 are the following:

- Alabama's "business privilege tax" (min. $100, max. $15,000);
- California's $800 fixed minimum tax;
- California LLC fees (min. $0, max $11,790);
- Georgia's annual net worth tax ($10–$5,000);
- Massachusetts imposes an excise base tax;
- New Hampshire's business enterprise tax;
- New Jersey fixed dollar minimum ($500–$2000);
- Nevada Commerce Tax;
- North Carolina's "franchise tax";
- Ohio Commercial Activities Tax;
- Oregon Corporate Activities Tax;
- Texas Margin Tax; and
- Washington Business & Occupation Tax.

ENDNOTES

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[1] *Wayfair Inc. v. South Dakota*, 585 US (2018).

[2] *Blue Buffalo Company, Ltd. v. Comptroller*, No. 495, Maryland Ct. Special Appeals (Dec. 20, 2019).