



Tax Update

California State Court Ruling Impacts Public Law 86-272 Interpretation

A recent decision by a California state court ruling on the relevance of Public Law 86-272 that presently restricts state taxes on out-of-state businesses may have wide-reaching impacts outside the state of California. As states continue to wrestle with the new interpretation of the aforementioned Public Law provided by the Multistate Tax Commission in its most recent version of the Statement of Information relating to the Public Law, the challenge brought by the American Catalog Mailers Association against the California Franchise Tax Board's Application and Interpretation may be instructive for how similar developments across the country tackle this issue, and what they may learn from the outcome of this decision.

The history of Public Law 86-272, codified at 15 U.S.C. § 381-384, begins in 1959 when Congress adopted the provisions that prohibited states from imposing 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: (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; and (2) the solicitation of orders by such person, or his representative, in such State in the name

of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).” 15 U.S.C. § 381(a)(1)-(2). Since enactment, however, the way businesses engage in interstate commerce has greatly changed with the advent and innovation of the internet and online businesses.

While Congress has not provided administrative guidance or otherwise opined, the aforementioned Multistate Tax Commission (“MTC”) has provided some assistance as it pertains to the situation. On August 4, 2021, the MTC provided a revised version of their ‘Statement of Information’ that discusses the Public Law and their position.¹ Specifically and most relevant, under the latest version of the Statement, a Section C concerning “Activities Conducted via the Internet” was added, discussing directly activities conducted over the internet and whether they are protected or not under the Public Law. The Statement specifically mentions that “an Internet seller is shielded from taxation in the customer’s state if the only business activity it engages in within that state is the solicitation of orders for sales of tangible personal property, which orders are sent outside that state for approval or rejection, and if approved, are shipped from a point outside of that state.”² The Statement goes further, mentioning the general rule that “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... [but] when a business presents static text or photos on its website, that presentation does not in itself constitute a business activity within those states where the business’s customers are located.”³

¹ A full version of the MTC Statement of Information can be accessed here (<https://www.mtc.gov/wp-content/uploads/2023/02/Statement-on-PL-86-272-FINAL-for-adoption-V2.pdf>)

² MTC Statement of Information, p8

³ *Id.*

Following the issuance of the latest Statement of Information advanced by the MTC in 2021, it then became the business of each state to determine the relevance of the latest changes. In the state of California, the Franchise Tax Board (“FTB”) largely adopted the Statement of Information when they released their Application and Interpretation of Public Law 86-272.⁴ Importantly, the FTB Publication added the same Section 3 discussing “Activities Conducted via the Internet” and mentioned that “an Internet seller is shielded from taxation in the customer’s state if the only business activity it engages in within that state is the solicitation of orders for sales of tangible personal property, which orders are sent outside that state for approval or rejection, and if approved, are shipped from a point out of that state.”⁵ The FTB adopted the same exact language from the MTC Statement of Information as it relates to interaction with a website or app as compared to static text or photos on a website.

Given the limited protections on activities that were to be shielded from taxation, it was no surprise when the American Catalog Mailers Association (“ACMA”) filed suit challenging the legality of the FTB Publication and TAM. Under the initial complaint, the Publication and TAM were alleged to be invalid and in contradiction with the provisions of the Public Law itself, the United States Constitution and the California Administrative Procedure Act (“CAPA”). In a December 13, 2023 Order, the Superior Court of California sitting in the County of San Francisco granted ACMA’s Motion for Summary Adjudication, finding the Publication and TAM advanced by the California FTB constituted invalid underground regulations that were directly in violation of the CAPA. In reaching this conclusion, the Court noted failure to comply

⁴ See FTB Publication 1050, Application and Interpretation of Public Law 86-272, here (<https://www.ftb.ca.gov/forms/misc/1050.pdf>). The California FTB also provided a Technical Advice Memorandum (“TAM”) that also discusses Public Law 86-272 (see the TAM here <https://www.ftb.ca.gov/tax-pros/law/technical-advice-memorandums/2022-01.pdf>)

⁵ FTB Publication 1050, p4

with the procedures of CAPA, and specifically that any agency advancing a regulation “must give the public notice of its proposed regulatory action; issue a complete text of the proposed regulation with a statement of the reasons for it; give interested parties an opportunity to comment on the proposed regulation; respond in writing to public comments; and forward a file of all materials on which the agency relied in the regulatory process to the Office of Administrative Law, which reviews the regulation for consistency with the law, clarity, and necessity.”⁶ Finding arguments advanced by the FTB that the Publication and TAM were not “regulations” under the CAPA to be weak, the court held the Publication and TAM were invalid for failure to comply with its procedural requirements. Shortly after the Court entered the Order, a proposed judgment was submitted by ACMA and entered by the Court which declared the Publication and TAM “void and without force or effect, and their guidance may not be relied upon.”⁷

The FTB more recently, and in response to the judgment entered by the Court, filed a Motion to Vacate and Modify the Judgment. With a hearing scheduled for February 14, 2024, the FTB requested the judgment be vacated by the Court on the grounds that the judgment did not follow the Order or applicable law. Specifically, the FTB argue they were given insufficient time to object to the proposed judgment entered by the Court as submitted by ACMA, and that the judgment exceeds the order, which they believe merely declared the Publication and TAM “void” and not “without force or effect.”⁸ The FTB requested the Court vacate and modify the judgment to omit the phrase “and without force or effect, and their guidance may not be relied

⁶ See Order Granting Plaintiff’s Motion for Summary Adjudication, *American Catalog Mailers Association v. Franchise Tax Board*, CGC 22-601363, p6

⁷ See FTB’s Notice of Motion and Motion to Vacate and Modify Judgment, *American Catalog Mailers Association v. Franchise Tax Board*, CGC 22-601363, p4

⁸ FTB’s Notice of Motion and Motion to Vacate and Modify Judgment, p5-6

upon,” in addition to removal of the paragraph from the judgment referring to ACMA as the “prevailing party.”⁹

The outcome of the Court hearing this month expects to have significant impact on not just businesses subject to tax in the state of California, but also around the country. While procedurally deemed to be void based on a California state law, the potential impact for businesses and their state taxes on out-of-state business cannot be understated in this modern-day age where a significant amount of business is completed over the internet. While the MTC Statement of Information and its provisions may be constitutional under federal law, not decided by the California court in the case brought against the FTB, the outcome and decision in the case make clear that as other states look to provide similar guidance for state taxation adopting the provisions of the MTC Statement of Information, each state must adhere to its rule-making and regulation provisions in order to achieve the intended effect on state taxes on out-of-state business as advanced by the MTC.

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⁹ FTB’s Notice of Motion and Motion to Vacate and Modify Judgment, p7-9