State of California
Franchise Tax Board

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Re: Analysis of Tax Nexus Issues Concerning the Commission on the 21st Century Economy's Business Net Receipts Tax Proposal

Memorandum

Executive Summary

California's Commission on the 21st Century Economy ("Commission") has asked the Franchise Tax Board ("FTB") for its views concerning various nexus issues relating to the Business Net Receipts Tax ("BNRT") proposal currently under consideration by the Commission. Those issues are:

1. What is the current state of the law concerning tax nexus? More specifically, should the BNRT's factor presence nexus standard pass constitutional muster?

2. Should the BNRT be viewed as more akin to an income tax or a sales tax for Commerce Clause nexus purposes, and should it be subject to Public Law 86-272?[1]

The answers to these questions cannot definitively be determined from current precedent. However, based upon the analysis below, we believe the courts should conclude, consistent with the majority of state court opinions, that an economic

[1] Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381-384).

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nexus factor presence standard is constitutional, and that the BNRT will be analyzed under the same standards utilized for income/franchise taxes. We also believe that the BNRT should not be subject to the provisions of Public Law 86-272.

<u>Analysis</u>

The BNRT Proposal

The relevant elements of the BNRT for purposes of this analysis are as follows (per the BNRT proposal circulated to Commission members on July 14, 2009):

1. A "privilege" tax would be imposed on all types of entities (including sole proprietorships) "doing business" in California; this tax would be measured by (that is, computed as a percentage of) the value added by the entity.

2. An entity would be deemed to be "doing business" in California if:

    a. the entity is organized or commercially domiciled in this state;
    b. the entity's sales in this state exceed the lesser of $500,000 or 25 percent of the entity's total sales;
    c. the entity's real and tangible personal property in this state exceeds the lesser of $50,000 or 25 percent of the entity's total real and tangible personal property; or
    d. the entity's payroll exceeds the lesser of $50,000 or 25 percent of the entity's total payroll.

3. The BNRT would be computed by applying a designated tax rate to the entity's post-apportionment BNRT base, which would consist of the entity's “gross receipts” for BNRT purposes (a defined term that excludes some items traditionally treated both as gross receipts and gross income, such as interest and amounts received from the sale of securities) less “purchases from other businesses” (another defined term limited to expenditures for rents, royalties, inventory, assets that are amortizable, depletable or depreciable, materials and supplies, and services (other than an entity's own payroll expenses)).

4. The BNRT tax base would be apportioned to California using a single “sales” factor, the ratio between the entity's sales in California and its sales everywhere.

5. In years in which the entity's gross receipts are exceeded by the entity's BNRT deduction for purchases from other businesses, the excess would be allowable as a carryover to reduce the entity's BNRT base in subsequent years.

6. Unitary business principles would be applicable utilizing a “water's edge” method.

The Extent of California's Jurisdiction to Tax

California's Corporation Tax Law provides that all corporations "doing business within the limits of this state and not expressly exempted from taxation by the provisions of the Constitution of this state or by [the provisions of the California Revenue and Taxation Code] shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income ...."[2] The term "doing business," in turn, currently is defined as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."[3] Commencing for taxable years beginning on or after January 1, 2011, the current doing business standard is amended to include a factor presence doing business standard, essentially identical to the BNRT's factor presence doing business standard discussed above.[4]

Standing alone, the foregoing statutes would appear to extend California's jurisdiction to tax quite far. However, the reach of California's jurisdiction to tax is constrained by the provisions of the Due Process and Commerce Clauses of the U.S. Constitution and by applicable federal statutes such as Public Law 86-272.[5]

Constitutional Limitations on California's Tax Jurisdiction – The Due Process Clause

The Due Process Clause of the U.S. Constitution provides, in pertinent part, that: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."[6] As applied in the state tax context, the Supreme Court has held that the Due Process Clause inquires into "whether the state has given anything for which it can ask return."[7] A taxpayer need not have a physical presence in the taxing state in order to satisfy the Due Process Clause (although a physical presence that is not *de minimis* clearly will suffice); all that is required is "some definite link [i.e., nexus], some minimum connection, between a state and the person, property or transaction it seeks to tax . . . and that the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state."[8]

The Due Process Clause primarily is concerned with the fairness of government activity, and with notice and fair warning of a potential tax obligation.[9] In general, the

[2] R.T.C. § 23151; see also R.T.C. § 23181.
[3] R.T.C. § 23101.
[4] See R.T.C. § 23101, as amended by Statutes 2009, 3rd Ex. Sess., Chapter 17, Section 7.
[5] California courts have found that under the current doing business standard "the reach of the California franchise tax is coextensive with the state's constitutional power to tax." *Appeal of Dresser Industries, Inc.*, 83-SBE-118, June 29, 1982, citing *Butler Bros. v. McColgan*, 17 Cal.2d 664, 667, affd, 315 U.S. 501 (1942); *Matson Navigation Co. v. State Bd. of Equal.* (1935) 3 Cal.2d 1, 8 (affd, 297 U.S. 441 (1936); *Lukenback S.S. Co. v. Franchise Tax Bd.* (1963) 219 Cal.App.2d 710, 722."
[6] U.S. Const. amend. XIV, § 1.
[7] *Wisconsin v. J.C. Penny Co.* (1940) 311 U.S. 435, 444; see also *National Geographic Soc. v. California Bd. of Equalization* (1977) 430 U.S. 551.
[8] *Quill Corp. v. North Dakota* (1992) 504 U.S. 298, 306-307 (internal quotation omitted).
[9] *Id*. at p. 312.

Due Process Clause will not prohibit a state from imposing a tax against a corporation that has "purposefully directed its activities" towards residents of the taxing state and has sufficient contact with that state, so long as the tax is related to the benefits the corporation receives from the state.[10]

Constitutional Limitations on California's Tax Jurisdiction – The Commerce Clause

The Commerce Clause of the U.S. Constitution provides, in pertinent part, that: "[t]he Congress shall have Power . . . [t]o regulate Commerce . . . among the several States."[11] The Commerce Clause has been interpreted as not simply authorizing Congress to regulate interstate commerce. Under what is known as the "negative" or "dormant" Commerce Clause principle, the Commerce Clause also prevents states from using their powers to unduly burden interstate commerce.[12] Thus, even in areas where Congress has not legislated, a state or local tax still may violate the Commerce Clause if it "unfairly burdens commerce" among the states.[13] If a dormant Commerce Clause challenge is mounted, a court will look at the economic effects of the challenged tax.[14] If the tax does not interfere with market efficiency by overburdening interstate commerce, the inquiry should end. Within these constitutional parameters, a state is entitled to exact "its fair share of state taxes" from companies engaged in interstate commerce.[15]

In *Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274, the Supreme Court held that a state tax will withstand a Commerce Clause challenge if the tax (1) is applied to any activity with a *substantial nexus with the taxing State*, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State.[16] The state tax must satisfy all four parts of this analysis to be upheld as constitutional.

The Constitutional Requirement of Tax Nexus -- A Two Part Analysis:

Will the BNRT's Factor/Presence Nexus Standard Satisfy the Due Process Clause's Nexus Requirement?

Although both the Due Process and Commerce Clauses contain a nexus requirement, the test for nexus under each clause is different because each clause addresses different constitutional concerns. This distinction was first delineated by the Supreme

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[10] *Id*. at p. 308.
[11] U.S. Const. art. I, § 8, cl. 3. This power is limited, at least in theory, by the Tenth Amendment to the Constitution, which provides that: "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X.
[12] *Quill, supra,* 504 U.S. at pp. 309-312.
[13] *Tyler Pipe Industries, Inc. v. Washington Dep't. of Rev.* (1987) 483 U.S. 232, 247.
[14] See generally, Trinova Corp. v. Michigan Dept. of Treasury (1991) 498 U.S. 358.
[15] *Quill* at p. 310, internal quotation omitted.
[16] This standard is commonly referred to as the "*Complete Auto* test."

Court in 1992 in *Quill Corp. v. North Dakota*.[17] There, the Supreme Court found that "the Due Process Clause and the Commerce Clause [we]re analytically distinct."[18] The Court also found that a taxpayer's physical presence in the taxing state was not a required element of nexus under the Due Process Clause. The Court explained:

> [W]e have held that if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State. As we explained in *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 85 L. Ed. 2d 528, 105 S. Ct. 2174 (1985):
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>> ... it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there."[19]

Thus, after *Quill*, the law was clear that the Due Process Clause's nexus requirement will be satisfied whenever a taxpayer has either a non-*de minimis* physical or an economic presence in the taxing state.[20]

Physical presence exists when a taxpayer has tangible property or personnel (including agents or representatives) in the taxing state.[21] Economic presence exists whenever a taxpayer, on its own or through an agent or representative, purposefully avails itself of the benefits of an economic market in the taxing state.[22] The BNRT's factor presence nexus standard sets forth a measure of a corporation's economic presence in California that almost certainly will satisfy the nexus requirement of the Due Process Clause.[23]

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[17] *Quill*, supra, 504 U.S. at p. 305.
[18] *Id.* For a state tax to be validly imposed, there must be sufficient nexus under both clauses. *Id* at p. 306.
[19] *Quill*, *supra*, 504 U.S. at p. 307, quoting from *Burger King Corp. v. Rudzewicz*, *supra*, 471 U.S. at p. 476.
[20] What constitutes a *de minimis* presence is less than clear. In *Quill,* the Court found that the physical presence of a few of the taxpayer's diskettes in the taxing state could be ignored as *de minimis* physical presence. *Quill*, *supra*, 504 U.S. at p. 315, fn 8.
[21] *Quill*, *supra*, 504 U.S. at pp. 306-308; see also *Scripto, Inc. v. Carson* (1960) 362 U.S. 207.
[22] *Quill, supra,* 504 U.S. at pp. 306-308.
[23] The BNRT's "doing business" standard is modeled on the Multistate Tax Commission's "factor presence nexus standard," which California adopted for corporate tax purposes for commencing in 2011. See http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

Will the BNRT's Factor/Presence Nexus Standard Satisfy the Commerce Clause's Nexus Requirement?

A considerably more difficult question is whether the BNRT factor presence nexus standard will satisfy the Commerce Clause's nexus requirement. The BNRT's factor presence nexus standard is essentially identical to the factor presence nexus standard California adopted last year;[24] however, this new standard has yet to be applied (it applies to taxable years commencing on or after January 1, 2011). Hence, its constitutionality has yet to be tested.

Although the U.S. Supreme Court discussed the Commerce Clause's nexus requirement in *Quill*, it did so only in the context of a use tax collection obligation. In *Quill,* the Supreme Court held that the Commerce Clause's "substantial nexus" requirement, as applied to a use tax collection obligation, contains a bright-line physical presence test.[25]

The Supreme Court has provided little guidance on the Commerce Clause's nexus requirement as applied to other types of taxes. In *Quill*, the Court stated that: "we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes ....."[26] Moreover, in *Quill*, the Court appeared to have retained the physical presence requirement *Bellas Hess* imposed with respect to use tax collection somewhat reluctantly, relying in part of the doctrine of *stare decisis.*[27] The Court also noted that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today."[28] Thus, the Court clearly left open the question of whether a physical presence requirement would be applied to other types of tax obligations.

In light of the Supreme Court's failure to address this issue, it has become the subject of vigorous debate by legal commentators and in the state courts.[29] Physical presence advocates assert that *Quill* supports their position that a corporation must have a physical presence in a state in order to be subject to that state's taxing jurisdiction because in *Quill* the Court stated that the physical presence requirement "furthers the ends of the dormant Commerce Clause."[30] They also argue that their position has the advantage of setting forth a clear, bright-line standard that

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[24] See Statutes 2009, 3rd Ex. Sess., Chapter 17, Section 7, amending R.T.C. § 23101.
[25] *Quill, supra,* 504 U.S. at p. 317. Although U.S. Supreme Court in *Complete Auto Body* articulated (and in *Quill* reaffirmed) a single formulation of the Commerce Clauses test for nexus, that of "substantial nexus to the taxing state," it left open the question of whether the quantum of "substantial nexus" required varies depending upon the type of tax obligation at issue.
[26] *Quill*, *supra*, 504 U.S. at p. 314, referring to *National Bellas Hess Inc. v Dept. of Rev. of the State of Illinois* (1967) 386 U.S. 753.
[27] *Stare decisis* is a Latin term meaning "to stand by things decided." It is a doctrine under which courts will follow earlier judicial decisions when the same points arise again in subsequent litigation.
[28] *Quill, supra,* 504 U.S. at p. 311.
[29] See the attached bibliography.
[30] *Quill*, *supra*, 504 U.S. at p. 314; see generally, A. Butler, *A Look at What the CAT Dragged in: The Problems Inherent in Ohio's Commercial Activity Tax* (Fall, 2006) 32 Dayton L. Rev. 99 (concluding physical presence nexus is required for all types of state taxes).

represents a logical extension of the Court's current nexus jurisprudence.[31] Physical presence advocates point to a handful of decisions that have employed a physical presence test for nexus.[32]

Economic presence advocates assert that in today's world corporations can conduct significant amounts of business in a state without having any physical in-state presence and that the only logical nexus standard for modern times is that of economic presence, as evidenced by purposeful exploitation of a state's economic market. Advocates of the economic presence test for nexus point to what they consider to be *Quill's* "reluctant affirmance" of the *Bellas Hess* physical presence requirement.[33] They also argue that the Court's statement that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first time today"[34] means that if the issue were to arise for the first time in a case involving a business activity tax (as opposed to a sales or use tax), the Court would *not* impose a physical presence standard.

Economic presence advocates point to two old Supreme Court decisions that they view as upholding application of an economic presence standard to business activity taxes. In *Int'l Harvester v. Wisconsin Dep't. of Taxation* (1944) 322 U.S. 435, the Supreme Court upheld the constitutionality of a Wisconsin tax on the privilege of declaring and receiving dividends. The tax was collected from a foreign corporation that was doing business in Wisconsin on dividends paid to both resident and nonresident shareholders. The Court stated: "it has never been thought that residence within a state or county is a *sine qua non* of the power to tax."[35] From this, the advocates conclude that physical presence is not required for imposing a

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[31] See, e.g., S. Smith and S. Amitay, *Economic Nexus: An Unworkable Standard for Jurisdiction,* 25 State Tax Notes 787 (2002); see also S. Smith, *MTC's Factor Presence Nexus Standards Are Unconstitutional,* 25 State Tax Notes 1043 (2002).
[32] In fact, an old, pre-*Quill* decision of the California State Board of Equalization ("SBE") supports the physical presence requirement. In *Appeal of John H. Grace Co.,* 80-SBE-115, Oct. 28, 1980, the SBE, after acknowledging that it "has a well established policy of abstention from deciding constitutional questions" appeared to view the physical presence requirement as an "existing constitutional limitation" on tax nexus, and "declined to follow the lead of the Oregon Supreme Court [in *American Refrigerator Transit Co. v. State Tax Commission* (1964) 395 P.2d 127] by accepting mere economic presence as constituting sufficient statutory nexus to support the corporate income tax." Physical presence advocates also claim that *J.C. Penney National Bank v. Johnson* (Tenn.Ct.App. 1999) 19 S.W.3d 831, rejected the economic presence test. Although the court in *J.C. Penney National Bank* found that the taxpayer's contacts with Tennessee failed to meet the substantial nexus test of *Quill,* in doing so it stated that "[i]t is not our purpose to decide whether 'physical presence' is required under the Commerce Clause." 19 S.W.3d at p. 842. Other, primarily older, state court decisions have simply assumed that physical presence nexus is required. See, e.g., *Gillette Co. v Mich. Dept. of Rev.* (Ct.App.Mich. 1993) 497 N.W.2d 595; contrast *Rylander v. Bandag Licensing Corp.* (Tex. Ct. App. 2000) 18 S.W.3d 296, 299, 301 (concluding that a Texas franchise tax based solely on a taxpayer's possession of license to do business in Texas was invalid, but not addressing whether the royalty payments received from the licensing of intangibles in Texas could satisfy the substantial nexus test).
[33] See, e.g., J. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective,* 31 State Tax Notes 341, 345 (2005).
[34] *Quill*, *supra*, 504 U.S. at p. 311.
[35] *Int'l Harvester*, *supra*, 322 U.S. at p. 443.

corporate business activity tax.[36] Advocates also cite *Wisconsin v. J.C. Penney Co.* (1940) 311 U.S. 435, in which the Court, sustaining the same tax that was involved in *Int'l Harvester,* stated that the requisite nexus is supplied if the corporation avails itself of the "substantial privilege of carrying on business within the State."[37] Economic presence advocates also note that the Supreme Court has refused to review several recent state court decisions that have refused to apply a physical presence test to business activity taxes.[38]

Finally, the Multistate Tax Commission ("MTC") has endorsed the economic presence nexus standard by adopting it as the basis for its Factor Presence Nexus Standard for Business Activity Taxes.[39] An economic presence test based upon factor presence (like that contained in both the MTC recommendation and the BNRT) sets forth a bright-line test for economic nexus that to a large extent neutralizes the argument of physical presence advocates that the physical presence test should be preferred over an economic nexus test because of its bright-line character.

In the absence of binding federal precedent, state courts have begun resolving the issue on their own. Although the vast majority of states have yet to address the issue, among those that have, most have held that for business activity tax purposes (i.e., state franchise and income taxes[40]), economic presence will satisfy the Commerce Clause's requirement of "substantial nexus to the taxing state."

For example, in *Lanco, Inc. v. Division of Tax'n* (N.J. 2006) 908 A.2d 176 (N.J. 2006), *cert. den.*, 127 S.Ct. 2974, the taxpayer, without a physical presence in New Jersey, licensed the use of its trademarks to related retail stores in that state. The New Jersey Supreme Court held that the taxpayer's physical presence in New Jersey was not required in order to subject the out-of-state intangible holding company to an income-based New Jersey tax.[41] The Court stated: "Simply put we do not believe that the Supreme Court intended to create a universal physical presence requirement for state taxation under the Commerce Clause."[42]

Similarly, in *MBNA Am. Bank, N.A. v. Tax Comm'r of State* (W. Va. 2006) 640 S.E.2d 226, *cert. den.* (2007) 127 S. Ct. 2997, the issue before West Virginia's highest court

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[36] See, D. Bucks and F. Katz, *Explanation of the Multistate Tax Commission's Proposed Factor Presence Nexus Standards,* 25 State Tax Notes 1037 (2002); see also J. Swain, *State Income Tax Nexus: Making the Case for an Economic Presence Standard in Light of Quill,* 9 Multistate Tax Rep. 965 (2002).
[37] *Wisconsin v. J.C. Penney Co.*, *supra*, 311 U.S. at pp. 444-445.
[38] Technically, the Supreme Court's denial of a petition for certiorari review is not indicative of how the Court might ultimately rule on the issue. However, the Supreme Court's failure to act in the face of what appears to be an emerging economic presence standard at the state level makes it somewhat less likely that the Court will ultimately overturn that emerging standard.
[39] See http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.
[40] The BNRT would come within the ambit of a business activity tax. The question of whether it would also be viewed as a net income tax for purposes of Public Law 86-272 is discussed below.
[41] *Lanco, supra*, 908 A.2d at p. 177.
[42] *Id*.

was whether a bank in the business of issuing and servicing credit cards could be subject to state tax based upon MBNA's economic presence in the state. MBNA had no employees or property in West Virginia but received over $18 million in gross receipts from West Virginia customers during the years at issue. The West Virginia Office of Tax Appeals held that imposing an income-based tax on MBNA, a business with no physical presence in the state, violated the Commerce Clause of the United States Constitution. The West Virginia Supreme Court of Appeals reversed, providing a number of reasons for its decision. First, it found that *Quill's* physical presence test was based primarily on the application of the *Bellas Hess* rule under the doctrine of *stare decisis*. Because *Bellas Hess* applied only to sales and use tax collection, it had no *stare decisis* applicability to franchise and income taxes.[43] Second, in *Quill* the Supreme Court expressly limited its holding to sales and use taxes.[44] Third, the court found that the compliance burden of paying franchise and income taxes was less than that involved in collecting and paying use tax.[45] Fourth, the court found that the physical presence test "makes little sense in today's world."[46] The court held that the taxpayer's continuous and systematic in-state solicitation, by telephone and mail, plus its significant in-state gross receipts ($18 million), satisfied the Commerce Clause's "substantial nexus" requirement.[47]

Other recent state court cases upholding an economic presence theory for imposing state business activity taxes include the following: *Geoffrey v. Comm'r of Revenue* (Mass. 2009) 899 N.E.2d 87, *cert. den.* (June 22, 2009) 2009 U.S. LEXIS 4584; *Bridges v. Geoffrey, Inc.* (La.Ct.App. 2008) 984 So.2d 115; *Capital One Bank v. Comm'r of Revenue*, No. C262391 and No. C262598 (Mass.App.Tax Bd. June 22, 2007): *A&F Trademark, Inc v. North Carolina* (N.C. Ct.App. 2004) 605 S.E.2d 187, *cert. den.* (2005) 546 US 821; *Kmart Corp. v. Taxation and Revenue Dep't* (N.M. Ct.App. 2001), 131 P.3d 22, rev'd on other grounds (2005); *Geoffrey v. South Carolina Tax Commission* (S.C. 1993) 437 S.E.2d 13, *cert. den.*, 510 U.S. 992 [holding Geoffrey’s in-state use of intangibles provided the necessary link to allow South Carolina to tax the royalties paid on those intangibles]; *Geoffrey, Inc. v. Oklahoma Tax Commission* (Ct.Civ.App.Okla., Div.One 2005) 132 P.3d 632, 638 [taxing out-of-state intangible holding company with no in-state physical presence; "we are satisfied that the physical presence requirement applicable to use and sales taxes is not applicable to income tax"].

In evaluating the current state of the law on the validity of tax regimes that are premised upon factor/economic nexus, one should consider not only state court decisions themselves (which, on balance, support the economic presence test), but also state tax statutes and practices. In this regard, several states (Michigan, Ohio, and Texas) recently have adopted tax regimes that are premised (at least in part)

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[43] *Id*. at p. 232.
[44] *Id*.
[45] *Id*. at p. 234.
[46] *Id*.
[47] *Id*. at p. 235-236.

upon an economic presence test for nexus.[48] Although these new tax laws are certain to be challenged in the courts, they (in conjunction with state court decisions and commentators supporting economic nexus) reflect what appears to be an emerging consensus that physical presence should not be viewed as an indispensable element of nexus for Commerce Clause purposes.[49] Although the risk that the United States Supreme Court will buck this trend cannot lightly be dismissed, it is concluded that the United States Supreme Court should follow this emerging trend if the issue come before it. If the United States Supreme Court fails to decide the issue, it will be decided by the California courts, and there is no reason to conclude that the risks should be evaluated differently at the state court level.[50]

Where, as here, the tax at issue is not an income tax but instead is a form of a value added tax, an additional unanswered question arises concerning whether such a tax imposes a collection obligation sufficiently similar to a use tax collection obligation such that the *Quill* physical presence nexus standard should be applied. However, the BNRT is clearly not similar to a use tax withholding obligation. It is not a transaction tax that is collected from the consumer and remitted to the state by the seller. Rather the BNRT is a tax on apportioned net receipts (value added) of the taxpayer. Under the BNRT it is possible that a taxpayer may pay no tax at all due to deductions for purchases, which cannot occur in a use tax scheme where the tax is based purely on the consumption of the product. Moreover, in *Trinova Corp. v. Michigan Dept. of Treasury* (1991) 498 U.S. 358, the United States Supreme Court, in evaluating the constitutionality of Michigan's SBT (a value added tax not unlike the BNRT), accepted the analogy of the SBT to an income tax and applied the same analysis in upholding the tax that the Court has applied to income taxes. The *Trinova* decision indicates that the courts should apply the same standards in evaluating the nexus standards for a value added tax (such as the BNRT) as they do in evaluating an income tax. Hence, we believe the BNRT should not be subject to any different analysis than would be applied in reviewing the constitutionality of the same nexus standards under the corporate franchise tax. [51]

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[48] See the Michigan Business Tax Act, Mich. Comp. Laws Ann. § 208.1101 (West. 2008); Ohio Rev. Code Ann. §5751.01(1)(3) (West 2006); Title 34, Tex. Admin. Code, § 3.586.

[49] This trend is further supported by the MTC's adoption of the Factor Presence Nexus Standard for Business Activity Taxes as one of its uniformity proposals.

[50] It also is important to keep in mind that regardless of how the courts ultimately rule on this issue, any tax that relies upon economic presence for nexus purposes under the Commerce Clauses runs the risk that the U.S. Congress could at any time undermine its tax regime by exercising its power under the Commerce Clause and *require* physical presence in the taxing jurisdiction as a prerequisite for taxation. This risk of Congressional action is not insignificant. Indeed, the adoption of such a requirement is one of the principal goals of the Business Activity Tax legislation that is currently pending before Congress. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009-2010).

[51] Although the U.S. Supreme Court applied a physical presence nexus test to Washington's business and occupations tax (a gross receipts tax), the applicability of the physical presence requirement was not disputed in that case and hence the decision is not precedential on that issue. See generally, *Standard Pressed Steel v. Wash. Dep't of Revenue* (1975) 419 U.S. 560; *Tyler Pipe Industries, Inc. v. Wash. Dep't of Revenue* (1987) 483 U.S. 232.

Public Law 86-272's Restriction on State Taxation

In addition to the *constitutional* limitations upon a state's ability to tax, there are also federal *statutory* constraints. Most significant in this regard is Public Law 86-272,[52] which prohibits a state from imposing a tax on, or measured by, net income, in specified circumstances where the taxpayer's only business activities in the taxing state consist of soliciting orders for the sale of tangible personal property. You have asked for the FTB's opinion as to whether the BNRT is potentially subject to the provisions of Public Law 86-272.

Public Law 86-272 provides, in pertinent part, as follows:

> No State … shall have power to impose, for any taxable year …, 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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> (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
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> (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).

Public Law 86-272 was hastily enacted in 1959 to overturn the result from two U.S. Supreme Court cases decided earlier that year, *Northwestern States Portland Cement Co. v. State of Minnesota* and *Williams v. Stockham Valves and Fittings, Inc.* 358 U.S. 450.[53] In those cases, the Supreme Court found that the in-state presence of persons soliciting sales on behalf of out-of-state entities provided a sufficient nexus to support the imposition of a corporate net income tax against the out-of-state entities.

In crafting Public Law 86-272, Congress presumably limited its scope to state net income taxes because they were the type of taxes authorized in *Northwestern States Portland Cement* and *Stockham Valves and Fittings, Inc.,* and because state net income taxes were the principal basis upon which interstate commerce was subjected to state taxation at the time.[54] Whatever

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[52] Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381-84).
[53] 1959 U.S.C.C.A.N. 2252, 2560.
[54] The Court in *Northwestern States Portland Cement* noted that, at the time of its decision, "thirty-five States impose direct net income taxes on corporations." 358 U.S. 452. See also, *General Motors Corp. v. Washington* (1964) 377 U.S. 436, 440, *revd. Tyler Pipe Indus. v. Wash. State Dept. of Rev.*

the source of this restriction, because Public Law 86-272 applies only to a "net income tax," the critical question is whether the BNRT would be viewed a net income tax within the meaning of the statute.

Will the BNRT Be Viewed as a "Net Income Tax" Within the Meaning of Public Law 86-272?

Public Law 86-272 defines a "net income tax" as "any tax imposed on, or measured by, net income."[55] The statute does not define the term "net income." In its common usage, "net income" generally is thought of as profit; that is, gross receipts less cost of goods sold and other allowable deductions.

> The term 'net income,' in law or in economics, has not a rigid meaning. Every income tax act necessarily defines what is included in gross income; what deductions are to be made from the gross to ascertain net income; and what part, if any, of the net income, is exempt from taxation. These details are largely a matter of governmental policy. As to them States differ; and there is apt to be difference of view in the same States at different times; and at the same time a different definition of taxable net income for different classes of taxpayers.

Atlantic Coast Line Railroad Co. v. Daughton (1923) 262 U.S. 413, 422, fn. 6.

Like most income taxes, the BNRT tax computation starts with the amount of a taxpayer's gross receipts.[56] From that amount, a taxpayer's "cost of purchases" is deducted, and the taxpayer's BNRT tax base is determined. The BNRT's "cost of purchases" deduction includes most, but not all, of the same types of expenses that are typically allowed as deductions in determining taxable net income. However, unlike an income tax, the BNRT does not allow deductions for the taxpayer's payroll-related expenses. Thus, for taxpayers with little or no payroll, the BNRT could be viewed as equivalent to a tax on income, whereas for taxpayers with no income and significant payroll, the BNRT could be viewed as equivalent to a tax on payroll. Or one could simply view the BNRT as being equivalent to a tax on the sum of the taxpayer's net income and payroll.[57]

Ultimately, the interpretation of Public Law 86-272 presents questions of federal law. However, the federal courts have not dealt with those questions. They have been addressed only in a handful of state court decisions. In *Gillette Co. v Mich. Dept. of Rev.* (Ct.App.Mich. 1993) 497 N.W.2d 595, 599, a Michigan appeals court considered whether Michigan's SBT, which, like the BNRT, was a type of value-added

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(1987) 483 U.S. 232, in which the Court noted that although it generally has sustained state net income taxes on interstate commerce, "local taxes measured by gross receipts from interstate commerce have not always fared as well."

[55] 15 U.S.C. § 383.

[56] The BNRT, however, excludes certain types of receipts typically included in an income tax computation, such as interest income.

[57] See generally, *Appeal of Kelly Services, Inc.*, 97-SBE-010, May 9, 1997, holding that the general operation of the tax will determine the nature of the tax.

tax, was subject to Public Law 86-272. The court concluded that it was not, because it was neither a tax on income nor a tax measured by income.[58]

> Although business income or federal taxable income is a starting point for and a component of the tax base, because of the extensive adjustments required to compute the single business tax, we cannot say that the tax is "measured by" net income.

Gillette Co. v Mich. Dept. of Rev. (Ct.App.Mich. 1993) 497 N.W.2d 595, 598-599. The court in *Gillette* also noted that:

> It seems likely that Congress, when enacting PL 86-272 to preclude the imposition of a net income tax upon foreign corporations whose activities in the taxing state were limited to mere solicitation, did not contemplate the creation or imposition of a value added tax. Nevertheless, we are bound by the plain words of the statute, which addresses only taxes "imposed on, or measured by, net income."

Id., at p. 599.

A recent Texas decision also supports the conclusion that the BNRT should not be viewed as an income tax within the meaning of Public Law 86-272. In *Inova Diagnostics, Inc. v. Strayhorn* (Tex. App.–Austin 2005) 166 S.W.3d 394, *cert. den.* (2006) 547 U.S. 1072, a Texas appeals court held that Public Law 86-272 did not apply to the taxable capital component of the state's franchise tax, notwithstanding the taxpayer's contention that because net income is included in the calculation of a corporation's taxable capital, the franchise tax should be viewed as a "tax imposed on, or measured by, net income."

In *Inova,* the court found that Public Law 86-272 must be narrowly construed because it preempted the state's power, and because it was intended as a limited stop-gap measure, while Congress was to study the issue further. The court also compared the tax definitions used in Public Law 86-272 with those in the Buck Act.[59] The Buck Act was a 1940 federal law that permitted states to levy and collect state income taxes on persons residing in a federal area within a state. It defined "income tax" as "any tax levied on, with respect to, or measured by net income, gross income, or gross receipts." From this, the court in *Inova* concluded that Congress clearly knew how to broadly define an income tax if it wished to do so. The court found that "[h]ad Congress intended Public Law 86-272 to be as broad as the Buck Act, it would have used similar language. Instead, Congress omitted any reference to gross income or

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[58] See also *Ardire v. Tracy* (Ohio Tax Commissioner 1997) 674 N.E.2d 1155, 1156 [citing *Gillette* extensively in holding that Michigan's SBT was not "imposed on, or measured by, net income]; *Clairol, Inc. v. Kingsley* (N.J. Super. Ct. App. Div. 1970) 262 A.2d 213, 216-217 (holding the net worth component of New Jersey's business tax was not "imposed on, or measured by, net income").
[59] 4 U.S.C. § 105 *et seq*. The Senate Finance Committee report on the Buck Act states that "The definition of income tax [in the Buck Act] is broad enough to include a sales tax which is measured by gross receipts from sales." Sen. Rep. No. 1625, 76th Cong., 3d Sess., p. 3 (1940).

gross receipts and only extended an exemption to net income taxes."[60] Thus, the provisions of Public Law 86-272 were narrowly construed to apply to taxes on net income only.

Although there are relatively few cases involving what constitutes a net income tax for purposes of Public Law 86-272, the issue of what constitutes a tax on income,[61] as opposed to a tax on gross receipts, has arisen in other, potentially distinguishable contexts. For example, states often condition their allowance of a deduction or credit for taxes paid to other jurisdictions based upon the nature of the type of tax involved, and the issue of what constitutes a gross receipts tax as opposed to an income tax has oftentimes arisen in that context. In *Appeal of Dayton Hudson Corp.*, 94-SBE-003, Feb. 3, 1994, the California Board of Equalization ("SBE") held that the critical inquiry for determining whether a tax is measured by something other than income was whether the tax base included an element of cost of goods sold or return of capital.[62] Thus, the Board held that Michigan's former SBT, which includes in its tax base an element of return of capital, was not a tax on gross or net income. Similarly, in *First Chicago NBD Corp. v. Indiana Dep't of State* (T.C.Ind. 1999) 708 N.E.2d 631, the Indiana Tax Court held that because the SBT included costs of goods sold in the tax base the tax was not one that was based on or measured by income, irrespective of the fact that federal taxable income was the starting point. In *Kellogg Sales Co. v Dept. of Rev.*, (1987) 10 Or.T.C. 480, affd. (Or. 1988) 766 P.2d 1029, the Oregon Tax Court held that a "net income tax" is one that taxes gain realized after payment of expenses necessary to earn income. Thus, the Oregon Tax Court held that the SBT was not a tax measured by or on net income or profits because it added back wages. In *Volusia County Kennel Club v. Haggard* (S Ct. Fl. 1954) 73 So.2d 884 *cert. den.* 348 U.S. 865, the Florida Supreme Court held that a gross receipts tax on gambling was a privilege tax rather than an income tax and therefore was not prohibited under Florida law.

The most relevant authorities (the state cases decided under Public Law 86-272) lead us to conclude that the BNRT probably would not be subject to the provisions of Public Law 86-272. However, because the scope of Public Law 86-272 is a question of federal law, and there are no federal authorities on the subject, it is hard to place a high degree of confidence in this conclusion. There is also a considerable risk that Congress might expand the scope of Public Law 86-272 in the course of the business activity tax legislation that has been under consideration in recent years.

<u>Conclusions</u>

The BNRT, if enacted, presents some novel tax issues that undoubtedly will lead to court challenges. The BNRT relies upon a factor presence nexus standard, the validity of which has not been addressed by the California courts or by the U.S. Supreme Court. We believe that such a standard should pass constitutional muster, although a

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[60] *Inova Diagnostics, supra*, 166 S.W.3d at p. 401
[61] Of course, Public Law 86-272 only applies to net income taxes.
[62] See also *Beamer v. Franchise Tax Bd.* (1977) 19 Cal.3d 467.

favorable outcome is not certain. We also believe that the BNRT should not be viewed as a tax on net income and would not, therefore, be subject to Public Law 86-272. Finally, there is a risk that the effectiveness of the BNRT could be undermined if the Business Activity Tax Simplification Act of 2009 currently under consideration in the U.S. Congress (or similar federal legislation) were to be adopted.

Please feel free to contact staff if there are additional areas of concern which you wish us to address.

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