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The 50th Anniversary of Stopgap Legislation

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1 of 1 DOCUMENT

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The 50th Anniversary Of Stopgap Legislation

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by Annette Nellen Annette Nellen is the director of and a professor in San Jose State University's Master of Science in Taxation program. She is an active member of the tax sections of the American Institute of Certified Public Accountants, American Bar Association, and California State Bar. She is the incoming chair of the Tax Policy, Practice and Legislation Committee of the California State Bar. Nellen maintains the 21st Century Taxation Web site and blog at http://www.cob.sjsu.edu/facstaff/nellen_a/TaxReform/21st_century_taxation.htm. This Web site includes a link to Nellen's Web site on Public Law 86-272 and the efforts and issues surrounding its modernization.

* * * * * September 14 marked the 50th anniversary of a federal law intended to serve as a stopgap measure until additional study could be made of the underlying, vexing state taxation issues. Despite much study, reports, and legislative proposals over the past 50 years, this stopgap law -- Public Law 86-272/1/ -- was never replaced with a more appropriate version as intended by many of the original drafters. Although this law is well known and used daily by tax practitioners and state auditors, most are too young to know of this law's early history and

intended temporary nature. Thus, we're unlikely to have any anniversary parties this year, and given the age of this temporary law that deals with an important topic, there really is no reason to celebrate.

After a brief review of P.L. 86-272 and how it came to be, this viewpoint makes observations on how things have changed (and not changed) in the past 50 years and the prospects for revising and modernizing this long-standing temporary law.

Background P.L. 86-272 arose from the need seen by many businesses and members of Congress to remove "the serious hazards inherent" in a 1959 ruling by the U.S. Supreme Court.^{/2/} Some businesses and members of Congress were concerned that the "broad scope of the language" of the Court, and the "apprehension that it has generated in the business community over the minimum amount of local activity within a state that would constitute a sufficient 'nexus' to subject a business to" income tax in a state, would dissuade businesses from pursuing new markets, thus harming the national economy.^{/3/}

The Supreme Court's ruling involved the companion cases *Northwestern States Portland Cement Co. v. Minnesota and Williams v. Stockham Valves and Fittings, Inc.*, 358 U.S. 450 (1959). Basically, the Court upheld the right of the states to subject a multistate business to income taxation if based on proper apportionment so that the state was taxing activities with a sufficient nexus in the state. The taxpayers involved had an office and sales personnel in the taxing states.

Perspectives on the ruling varied. Many in Congress believed that swift action was needed to prevent states from reaching out more broadly to subject multistate businesses to income taxation. P.L. 86-272 was enacted within just seven months of the issuance of the Court's ruling.

P.L. 86-272 provides guidance on when a state may subject a taxpayer to state income tax. Thus, it explains when a business has nexus with a state. Basically, if the only business activities in a state are the solicitation of orders for sales of tangible personal property and those orders are approved and filled from outside the state, the business does not have nexus in the state for net income tax purposes. If the orders are taken by independent contractors, there is a bit more leeway allowed under P.L. 86-272, on grounds such as an office in the state.

There was a fair amount of debate among legislators as to the need for quick action and the effect on the states. State governments were concerned about a possible loss of revenue from the congressional approach. For example, Sen. John Carroll said that he had received information from Colorado that it would potentially lose millions of tax dollars from the proposal.^{/4/} Some state government officials were concerned that Congress was reaching beyond its commerce clause powers and limiting the rightful authority of states to tax income earned within its borders. One state tax collector viewed P.L. 86-272 as a raid on state tax coffers, with Congress acting beyond its authority because the Court's ruling did not involve taxes "upon interstate commerce but rather upon net income earned within the state."^{/5/}

Some legislators also expressed concern that the bill would enable multistate businesses to avoid income taxes in a state in which it had customers while local businesses would be subject to tax, thus causing competitive disadvantages.^{/6/}

Despite its quick enactment, limited application, and some opposition to its approach, P.L. 86-272 has provided a high level of certainty to businesses that fall within its purview. Also, states have provided guidance to help businesses and auditors apply this law. However, the law has failed in that it provides no guidance to businesses selling services and intangibles or on other types of business activity taxes, such as a gross receipts tax. That failure is made worse by the amount of time an incomplete and stopgap law has been left to stand.

Stopgap Nature and Post-1959 Actions The Senate report to P.L. 86-272 explains the intended temporary nature of the legislation:

Your committee [Senate Finance] recognizes that the bill it has reported is not a permanent solution to the problem that

exists. It was not intended to be. Your committee, like the Select Committee on Small Business of the U.S. Senate, recognizes that the problem is a complex one which requires extensive and exhaustive study in arriving at a permanent solution fair alike to the States and to the Nation. Your committee believes, however, that the bill it has reported will serve as an effective stopgap or temporary solution while further studies are made of the problem./7/ However, in what turned out to be a prophetic comment by Sen. Albert Gore Sr., the bill would not be stopgap legislation because no termination date was specified./8/

P.L. 86-272 also called for a study and report by Congress. This study was to fully address "all matters pertaining to the taxation by the States of income derived within the State from the conduct of business activities which are exclusively in furtherance of interstate commerce or which are part of interstate commerce." The purpose was to allow for recommendations to provide uniform standards for the imposition of income taxes by the states. The report was due by July 1, 1962.

In 1961 the scope of the study was broadened to include the state sales tax./9/ In 1964 and 1965 a comprehensive report exceeding 1,200 pages was issued with details on the operation of state tax rules, issues, and possible solutions. This report is referred to as the Willis Commission report after Rep. Edwin E. Willis, who chaired the special subcommittee that drafted the report./10/

Although many proposals were introduced in Congress after the issuance of the Willis Commission report, no changes were made to the operation of P.L. 86-272. A 1982 General Accounting Office (now Government Accountability Office) report on multistate tax issues said that state opposition was the primary reason that nothing further was enacted. The states believed that state-level actions on uniformity and other income tax matters would be a better approach than federal legislation./11/

In recent years, bills have been introduced to modernize P.L. 86-272, such as H.R. 1083 (111th Cong., 1st Sess.), S. 1726 (110th Cong., 1st Sess.), and H.R. 5267 (110th Cong., 2nd Sess.). While a few hearings have been held in the past several years, nothing has passed in either house of Congress, although H.R. 1956 (109th Cong., 2nd Sess.) passed in the House Judiciary Committee.

Change Versus No Change Although 50 years have passed since P.L. 86-272 was enacted, many of the issues inhibiting its modernization are similar to those raised in 1959 in drafting the law. Those issues primarily involve challenges of reaching agreement between the competing interests and concerns of businesses and state governments. Businesses tend to want a physical presence nexus standard because of the certainty and objectiveness it provides. Another justification offered for a physical presence standard is that it ties better to the government benefits obtained when a business has property and/or employees in a state. In contrast, state governments are concerned that a physical presence standard does not consider today's ways of doing business in which commerce can easily be transacted in a state without the need to have property or payroll in the state. State governments also argue that the legislative proposals to modernize P.L. 86-272 would result in a loss of aggregate state tax revenue. Also, states charge that the new proposals intrude on state sovereignty./12/

Meanwhile, significant changes have occurred in the economy: The types of transactions not covered by P.L. 86-272, namely sales of services and intangibles, have become far more prevalent. Thus, the number of situations in which P.L. 86-272 provides guidance is limited.

Lack of definitive action by Congress has left states to interpret appropriate nexus standards based on their interpretations of the U.S. Constitution's due process and commerce clauses. In several states, that standard has moved from one of physical presence to one of economic nexus./13/ The economic nexus standard is mostly subjective, while

the standard of P.L. 86-272 is mostly objective.

As noted earlier, many of the pro and con arguments made years ago when P.L. 86-272 was being deliberated are raised today as well. In 1959, arguments opposing P.L. 86-272 included loss of state revenue, an adverse affect on small businesses that would not be able to avoid state income taxes, and the fact that federal legislation might not be the best approach. Those issues continue today.

At least one premise for arguing for a particular approach has changed somewhat with the times. Years ago, one commentator said that "today's jet age" blurred interstate and intrastate activities "as a matter of economic fact."¹⁴ Of course, a factor for suggesting why modernization of P.L. 86-272 is needed today is the information age, in which borders are less important to the ability to complete transactions and a physical presence is not always needed to serve customers.

Lessons Learned What has been learned in the 50 years since enactment of the temporary P.L. 86-272? Arguably, the lesson suggested by Gore is relevant. If a law is intended to be temporary while Congress studies how to create a better solution, the legislation should specify a termination date to improve the chances of follow-up action in the short term.

Also, an effective forum is needed to resolve competing interests rather than just letting arguments continue for decades. While the arguments and positions of businesses and state governments have been studied and reported on in depth, little action was taken to find common ground and approaches that might have led to a solution acceptable to all parties. Although the solution reached by such a give-and-take process might not be the ideal solution either party sought, compromise could have brought resolution and greater certainty to the area of state income tax nexus.

Little, if anything, has been gained by either side during the past five decades of repeating the same arguments without reaching a solution. Businesses have not obtained certainty as to when nexus exists for all types of transactions that can generate state income tax liabilities. And state governments have not benefited from the uncertainty and litigation regarding when they have authority to impose state income tax in the growing number of transactions in which P.L. 86-272 does not apply.

Realistic compromise should mean consideration of the important features of effective taxation for both businesses and state governments. Businesses need certainty and compliance obligations that won't discourage interstate sales activity. State governments need revenue to reflect the reality of the costs of the protection, opportunities, and benefits/¹⁵ their infrastructure and economy provide to multistate companies. An example of a compromise would be for businesses and state governments to consider appropriate *de minimis* or safe harbor provisions in a modernized P.L. 86-272.

Moving Forward The 50th anniversary of a temporary law is not a time to celebrate, but a time to reevaluate the situation and find a way to address what has arguably been a failure of process. That failure has led to continued replay of the 1959 debate on how Congress should exercise its authority under the commerce clause for effective state income taxation of multistate businesses. It is time to end the reruns and move onto a new season. Both businesses and state governments have been harmed by the uncertainty and costs of litigation and need a better approach than the overextended status quo.

Some proposals to update P.L. 86-272 (noted earlier) have been introduced multiple times without success. That likely indicates a need to consider alternative approaches, as well as to work on the art of compromise. There are several suggestions and approaches already in existence. For example, the permanent establishment rule used in the international context to determine when an entity is subject to tax in a foreign country could be considered. Alternatively, an approach to modify economic nexus to make it a more objective rule could be explored. Also, the factor presence approach/¹⁶ with modification, such as scaling to the size of the entity, should be considered. Although defining state income tax nexus is a challenging problem, it is not impossible to resolve.

I hope the flaw of reaching the 50th anniversary of stopgap legislation will be a wake-up call for all parties to strive to reach a workable solution in defining state income tax nexus for today's ways of doing business.

FOOTNOTES /1/ Public Law No. 86-272, 73 Stat. 555, 15 U.S.C.A. sections 381-384 (Sept. 14, 1959).

/2/ 105 Cong. Rec. 16362 (1959) (statement of Sen. Kenneth Keating).

/3/ S. Rep. No. 658, 86th Cong., 1st Sess., reprinted in 1959 U.S.C.C.A.N. 2550-2551 (1959).

/4/ 105 Cong. Rec. 16367 (1959).

/5/ Robert L. Roland, "Public Law 86-272: Regulation or Raid," 46 Vir. L. Rev. 1172, 1173 (1960); Roland was collector of revenue for Louisiana.

/6/ S. Rep. No. 658, 86th Cong., 1st Sess., reprinted in 1959 U.S.C.C.A.N. 2559 (1959).

/7/ S. Rep. No. 658, 86th Cong., 1st Sess., reprinted in 1959 U.S.C.C.A.N. 2551.

/8/ 105 Cong. Rec. 16357 (1959).

/9/ P.L. 87-17, 75 Stat. 41 (1961).

/10/ Special Subcommittee on State Taxation of Interstate Commerce, House Comm. on the Judiciary, State Taxation of Interstate Commerce, H.R. Rep. No. 1480, 88th Cong., 2nd Sess. (1964) and H.R. Rep. No. 565, 89th Cong., 1st Sess. (1965). For an overview of the report, see W. Val Oveson, "Lessons in State Tax Simplification," State Tax Notes, Jan. 28, 2002, p. 283, Doc 2002-2080, or 2002 STT 18-39.

/11/ General Accounting Office, "Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving," GAO/GGD-82-38, July 1, 1982, 6-7.

/12/ Much has been written on the positions of businesses and state governments on the approach to modernizing P.L. 86-272. For a list of references, primarily testimony before Congress in recent years, see the author's Web site on the 50th anniversary of P.L. 86-272, available at http://www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm.

/13/ See, e.g., Tax Commissioner of the State of West Virginia v. MBNA America Bank, N.A., 640 S.E.2d 226 (S.Ct. WV, 2006), cert. denied, 127 S.Ct. 2997 (2007). (For the decision, see Doc 2006-23668 or 2006 STT 228-18.)

/14/ Roland, *supra* note 5, at 1179.

/15/ Wisconsin v. JC Penney, 311 US 435, 444 (1940).

/16/ Multistate Tax Commission, "Factor Presence Nexus Standard for Business Activity Taxes," Oct. 17, 2002.

END OF FOOTNOTES

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