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California Judge Allows ACMA Suit Over P.L. 86-272 Guidance

by Paul Jones

A San Francisco judge has ruled that the American Catalog Mailers Association's suit against California's recent P.L. 86-272 guidance can continue.

"The California Franchise Tax Board's (FTB) demurrer to the American Catalog Mailers Association's (ACMA) 'complaint for declaratory relief' is overruled," San Francisco Superior Court Judge Richard B. Ulmer Jr. wrote in a November 17 order in *American Catalog Mailers Association v. Franchise Tax Board*. Ulmer rejected all three of the FTB's arguments, finding them to be unavailing.

The ACMA's lawsuit was filed August 19 on behalf of the association's members, which include remote sellers of tangible goods. The suit challenges California's guidance outlining changes to how the state will interpret and enforce P.L. 86-272, the 1959 federal law that says a state can't tax the income of an out-of-state seller of tangible personal property if the seller's in-state activities are limited to soliciting sales and approving and shipping orders to in-state buyers from out of state. The guidance, TAM 2022-01 and Publication 1050 (FTB 1050), adopt new interpretations approved by the Multistate Tax Commission in August 2021. They say that a range of non-solicitation-related activities by a seller that are carried out over the internet — such as using cookies to track shoppers' internet searches for advertising purposes or providing software updates to customers' products — can be treated as activities that take place in a state where those shoppers or customers are located, costing the seller its protection under P.L. 86-272.

According to California's guidance, a seller carrying out such activities in the state via the internet is no longer protected under P.L. 86-272 from the state's income tax and franchise tax, meaning a substantial number of online retailers could now be liable. The ACMA's suit, which seeks to invalidate the guidance, warns that the rules as written can be enforced retroactively, creating a significant risk for online sellers with years of previous sales into California.

The FTB sought to have the suit dismissed, asserting that a challenge could go to court only after a taxpayer had paid tax under the disputed guidance. It also argued that the suit wasn't ripe and that the ACMA lacked standing to bring it.

But Ulmer rejected those arguments. There's no need to first pay a tax, he wrote, saying that "the complaint nowhere pleads a tax assessment." He also determined that the case is ripe because the issue in question "is both 'sufficiently concrete to make declaratory relief appropriate' and 'withholding of judicial consideration will result in a hardship to the parties.'"

Lastly, Ulmer ruled that the ACMA has standing because "an 'association has standing to bring suit on behalf of its members'" when the members would have standing to sue themselves, adding that "the interests it seeks to protect are germane to the organization's purpose" and "neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit," quoting the California Court of Appeal's 2019 decision in *United Farmers Agents Association Inc. v. Farmers Group Inc.*

Reactions

Hamilton Davison, president and executive director of the ACMA, praised the decision in a statement emailed to *Tax Notes* November 18.

"We are pleased with the Court's ruling yesterday, which permits us to litigate on the merits our claim that the California Franchise Tax Board's regulation . . . would subject [to state income taxation] our members who do not step foot in California but merely use cookies and emails from their websites located outside of California," he said.

In a November 18 release, the ACMA said, "The TAM as applied meant that the FTB would require virtually every ACMA member that did not engage in any activities in California to pay the California income tax, which is at one of the highest rates in the country."

The decision was also welcomed by Martin I. Eisenstein, the managing partner of Brann & Isaacson, which represents the ACMA. In an emailed statement, he noted that Ulmer "agreed with ACMA's position that an out-of-state taxpayer who has not been assessed the California income tax may litigate" the state's new interpretation of P.L. 86-272 in court. "The taxpayer does not need to await an assessment,

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then pay the assessment and file a claim for refund, in order to join issue on the validity of the Franchise Tax Board's position," he said.

Background

The ACMA originally sent the FTB a letter urging it to withdraw the guidance but said it never received a response. In its lawsuit, the association argues that the FTB violated the state's Administrative Procedure Act, in part by failing to offer interested parties an opportunity to weigh in on the new interpretations. It also argues that retroactive application of the guidance would violate the due process rights of its members and other taxpayers and challenges the lawfulness of the guidance's interpretation of P.L. 86-272 and, by extension, the lawfulness of the MTC's new interpretation of the law. The suit says the TAM's interpretation of P.L. 86-272 disregards the law's meaning by erroneously treating activities conducted over the internet by businesses as activities carried out in the state of a shopper or customer.

"The FTB's radical new interpretation of P.L. 86-272, as articulated in the TAM and FTB 1050, rests on the erroneous conclusion that a business engages in activities within California if it maintains an internet website permitting any kind of interaction with a California resident, even if the website is hosted entirely on servers located outside of California," according to the suit. "The development of the internet, however, has not altered the meaning of the words contained in P.L. 86-272, nor has the fact of the internet altered the nature of basic business practices."

California's TAM, like the MTC's updated guidance, notes that the Supreme Court's decision in *South Dakota v. Wayfair Inc.* found that internet sellers "may be present in a State in a meaningful way without that presence being physical in the traditional sense of the term." Although *Wayfair* didn't address P.L. 86-272, "California considers 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 P.L. 86-272," according to the TAM.

The ACMA counters in its complaint that the *Wayfair* decision doesn't mean that online activities by a business can now be treated by a state as being carried out "in-state" for purposes of defeating a seller's protection under P.L. 86-272.

"In contrast to the sales tax nexus standard addressed in *Quill*, *Bellas Hess*, and *Wayfair*, P.L. 86-272 is a federal statute, the result of an affirmative exercise by Congress of its positive authority under the Commerce Clause," the ACMA said. "Only Congress, not the Supreme Court, can amend a federal statute."

The FTB declined to comment on the case.

In *American Catalog Mailers Association v. Franchise Tax Board* (Case No. CCG-22-601363), the ACMA is represented by Eisenstein, George Isaacson, Nathaniel Bessey, and David Swetnam-Burland of Brann & Isaacson and Richard Pachter of the Law Offices of Richard Pachter. ■

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