

California Court Ruling on Interstate Tax Law Will Make Waves

KPMG's Shirley Sicilian explains why a Feb. 14 California court hearing could determine the role of a federal law involving state taxation of interstate businesses in the era of online commerce.

California was the first state to adopt the Multistate Tax Commission's [revised interpretation](#) of [Public Law 86-272](#), a federal law that levies restrictions on state taxes of interstate businesses. And by Feb. 14, we expect the San Francisco Superior Court will become the first court to finalize a ruling on it.

Unfortunately, the court won't be ruling on the substance of the commission's revised [interpretation](#). Instead, it will rule on whether the California Franchise Tax Board followed required procedures in adopting it.

At issue is a motion for summary judgment [filed by](#) the American Catalog Mailers Association, or AMCA, on its second count: that the board's adoption of the commission's revisions through agency guidance were underground regulations passed without adherence to the state's Administrative Procedures Act.

If the court stays its course, declares the guidance void, and is upheld on any further appeal, it will be a win for interstate businesses with customers in California. The California Administrative Procedures Act, like most states', requires an opportunity for public input and for the state respond to that input. This is a good approach for an issue as controversial as the commission's PL 86-272 interpretation.

Confirmation of the original ruling also may give pause to other states considering adoption. While New York has adopted the interpretation by regulation, and Oregon has proposed adoption by regulation, other states—including New Jersey and Minnesota—have issued only guidance. Indeed, some states appear to be adopting the position solely on audit, without issuing guidance or notice of any kind.

If AMCA wins on the regulatory issue in California, the substantive issues regarding reasonableness of the state's PL 86-272 interpretation itself—and

whether that interpretation can be applied retroactively by regulation—could be taken up after appeals are exhausted on the regulatory issue and/or the state pivots to adopt its guidance as a regulation.

Depending on how long all of this takes, we may see another case crop up and take the lead in one of the other adopting states. However, if the court is persuaded by the Franchise Tax Board, it would likely vacate its judgment requiring a regulation. A loss is a loss, but the court could potentially move on to trial on the substantive issues—a silver lining of sorts.

All indications are that the board would face a similar uphill battle. Although AMCA's motion for summary judgment on the substantive issue was denied in August 2023, the court's denial expressed "significant concerns as to the board's interpretation and application of PL 86-272."

Getting an answer on the substantive issues is critical for businesses and practitioners, most immediately on the retroactivity question. The commission recommended the revisions be adopted prospectively.

But California and some other states aren't following that advice. When a state adopts the revisions and immediately begins applying them on audit, the position is being taken retroactively and without notice with respect to those open years still subject to audit.

A business that had been protected by PL 86-272 could suddenly find itself assessed, even where there has been no change in business operations, no change in the federal statute, and no change in any state law.

It's especially troubling to business and practitioners when a state takes the position without issuing any guidance at all. The Multistate Tax Commission's revisions are arguably aggressive and certainly controversial. Businesses are unlikely to just assume a state has adopted them. And no business wants to have to wait for an audit to find out.

Whether or not the Constitution requires it, the better approach is for a state to provide notice, ideally coupled with a grace period so businesses can prepare for tax impositions by potentially large numbers of states.

Whichever way the San Francisco Superior Court rules, keep in mind this is only early-stage litigation in the first state to be challenged. The California guidance

stays in place until all appeals have been exhausted, unless the state chooses to retract it or pause enforcement.

And that could take some time. No matter which state takes the lead, this is the sort of issue that has the potential for US Supreme Court review. The matter involves whether states have properly interpreted a federal statute, the weight that should be given to that interpretation, and constitutional due process notice requirements.

In addition, we may see states challenge PL 86-272 itself by arguing Congress overstepped its authority under the affirmative commerce clause in enacting these federal protections.

In the meantime, this court's ruling will be another bit of helpful information for businesses and practitioners considering how they want to account for the uncertainty of whether interpretation by the Franchise Tax Board and other adopting states ultimately will be upheld or struck down.

The case is *American Catalog Mailers Association v. Franchise Tax Board*, CGC22601363, arguments 2/14/24.

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