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I. State Taxation of Interstate Commerce: The Problem

To fund new or existing state programs, many states impose taxes on corporations organized and operating within their boundaries. Other states impose taxes on corporations that, although organized and operating in a different state, transact some business within their state. These taxes may be franchise taxes,[1] income taxes, or a combination of both.[2]

The imposition and enforcement of state taxes upon businesses engaged in interstate commerce raises questions not only under the Constitution,[3] but also under a federal statute, Public Law 86-272.[4] An example may be helpful in illustrating these questions.

Suppose a corporation in State *X* wants to expand its operations into State *Y*. The corporation could select one or

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*105 Cong. Rec. 17,771 (1959) (statement of Rep. Emanuel Celler, quoting Mr. Churchill).

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1. Taxes levied on corporations for the privilege of doing business within a state.

2. *See, e.g.*, Cal. Rev. & Tax Code §§ 23101-114 (West 1979) (imposing a franchise tax on banks, financial corporations, and all corporations generally, whether or not qualified, organized and operating within California, and those out-of-state corporations, including foreign corporations, doing business in the state); *id.* at §§ 23501-504 (levying an income tax on corporations deriving income from California sources, but not sufficiently present to be classified as "doing business" in the state). Under these statutes a corporation is subject to either the franchise tax or the income tax, but not both.

3. U.S. Const. art. I, § 8, cl. 3 (commerce clause); and *id.* at amend. XIV, § 1 (due process clause). For a detailed historical and chronological discussion on judicial use of the commerce clause and the due process clause as federal limits on state taxation of commerce, see P. Hartman, Federal Limitations on State and Local Taxation §§ 2:1 to 2:20 (1981).

4. Act of Sept. 14, 1959, Pub. L. No. 86-272, 73 Stat. 555 (codified at 15 U.S.C. §§ 381-384 (1982)). Although technically a statute, 15 U.S.C. §§ 381-384 are commonly referred to as Public Law 86-272. The text of Public Law 86-272 is set forth in Appendix I.

more of the following marketing strategies to sell its products to citizens of State *Y*:

(1) Advertise its products in a publication that is distributed in State *Y*;
(2) Solicit orders in State *Y* by phone from State *X*;
(3) Employ salesmen to traverse State *Y* in search of orders;
(4) Hire independent contractors who are citizens of State *Y* to obtain orders;
(5) Establish a branch sales office (or offices) in State *Y*; or
(6) Create a subsidiary to transact business in State *Y*.

For purposes of this example, assume that the corporation has no offices and owns no land in State *Y*. Under which of the above strategies may State *Y* impose a tax on the corporation's income earned from product sales to citizens of State *Y*? In other words, what nexus is required before a state can tax an out-of-state company on income earned in interstate commerce?[5] Congress enacted Public Law 86-272 to answer the preceding question. Its solution has apparently failed. This article principally deals with Public Law 86-272: its history, enactment, interpretation, intended coverage, and failure.

II. The Commerce Clause and Early Attempts to Define the Required Nexus

One of the earliest attempts by a state to tax income derived from interstate commerce resulted in the Supreme Court decision of *United States Glue Co. v. Oak Creek*.[6] In *United States Glue*, a glue manufacturer (United States Glue Co.) produced goods at a factory in Wisconsin and sold some of these goods to customers outside the state. Wisconsin levied a general income tax on the company's net income, including the income derived from the sale of goods in interstate commerce. United States Glue Co. objected to Wisconsin's action, claiming that the tax contravened the commerce clause of the Constitution. In an opinion that apparently approved such taxation, the Supreme Court held that a domestic corporation may be taxed in its home state on income earned in interstate commerce if the tax is lev-

5. One commentator has described the problem of state taxation and interstate commerce as "a riddle wrapped in an enigma inside a mystery." 105 Cong. Rec. 17,771 (1959) (statement of Rep. Emanuel Celler, quoting Mr. Churchill).

6. 247 U.S. 321 (1918).

ied on the net income of the corporation and not on the corporation's gross receipts.[7] The Court also recognized that a state could levy franchise taxes on nondomestic companies engaged in interstate commerce if the company owned property in the taxing state.[8] However, the Court did not approve state taxation of nondomestic companies owning no property in the taxing state.

Between 1918 and 1958, numerous decisions discussed the validity of state taxation of interstate commerce.[9] "[T]he task of reconciling all the decisions is more difficult than was the task of Theseus as he threaded his way through the famous Cretan labyrinth in search of the Minotaur."[10]

In 1959, the Supreme Court handed down its decision consolidating *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings, Inc.*[11] In these cases the Court attempted to delineate clearly a state's ability to tax the apportioned net income of out-of-state businesses engaged exclusively in interstate commerce. In both cases, an out-of-state company maintained offices, and employed salesmen who solicited orders, within the taxing state. The orders were sent outside the state for approval and delivery.

In approving taxation of these two companies, the Court held that "net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same."[12] The local activities that formed a sufficient nexus in these cases apparently were the maintenance of an office and the solicitation of orders by company salesmen.

After its decision in *Northwestern Cement* and *Stockham Valves*, the Court denied certiorari in *Brown-Forman Distillers Corp. v. Collector of Revenue*[13] and *International Shoe Co. v.*

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7. *Id.* at 328-29.

8. *Id.* at 326-27.

9. Mr. Justice Clark, in Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-58 (1959), commented that the Supreme Court "alone has handed down some three hundred full dress opinions spread through slightly more than that number of our reports" dealing with the validity of state taxation under the commerce clause and the due process clause.

10. Roy Stone Transfer Corp. v. Messner, 377 Pa. 234, 243-44, 103 A.2d 700, 705 (1954).

11. 358 U.S. 450 (1959).

12. *Id.* at 452.

13. 359 U.S. 28 (1959), *denying cert. to* 234 La. 651, 101 So. 2d 70 (1958).

Fontenot.[14] In these two decisions, the respective state courts significantly stretched *Northwestern Cement's* reasoning by allowing the imposition of a state income tax on out-of-state corporations even though the corporations did not maintain any offices or warehouses within the taxing state.[15]

The denials of certiorari sparked an outcry of apprehension from the business community.[16] Businessmen were concerned that the mere solicitation of orders within a state would subject an out-of-state corporation to an income tax levied by the state.[17] Businessmen also worried that they might be forced to pay income taxes in every state where their goods were sold.[18] The need for some type of legislative solution was obvious.[19]

Reacting to the concerns of the businessmen, Congress debated over the correct solution. The status quo was unacceptable because a continuation of the principles established in *Northwestern Cement* and *Stockham Valves* as interpreted in the *Brown-Forman* and *International Shoe* decisions[20] would inflict a substantial burden on interstate commerce.[21] In discussing this

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14. 359 U.S. 984 (1959), *denying cert. to* 236 La. 279, 107 So. 2d 640 (1958). This case should not be confused with the more famous case of International Shoe Co. v. Washington, 326 U.S. 310 (1945).

15. In *Brown-Forman,* the company employed "missionary men" who traversed the state and called on local distributor-wholesalers. These missionary men would assist the wholesalers in displaying merchandise and would relay, but not solicit, orders for merchandise. The company did not maintain a permanent office or warehouse in the taxing state. 234 La. at 653-54, 101 So. 2d at 70.

In *International Shoe,* the company hired 15 salesmen to systematically solicit orders in the taxing state. The company did not maintain a permanent office in the taxing state. 236 La. at 280, 107 So. 2d at 640. The salesmen drove company vehicles and displayed the company's samples in local hotels or public buildings. P. HARTMAN, *supra* note 3, § 9.8, at 477-78.

16. *See State Taxation on Interstate Commerce, 1959: Hearings Before the Senate Select Committee on Small Business,* 86th Cong., 1st Sess. 1-356 (1959) [hereinafter cited as *Hearings, Small Business Committee*]; *see also* SENATE COMM. ON FINANCE, STATE TAXATION OF INCOME DERIVED FROM INTERSTATE COMMERCE, S. REP. No. 658, 86th Cong., 1st Sess. 1-3, *reprinted in* 1959 U.S. CODE CONG. & AD. NEWS 2548, 2549.

17. S. REP. No. 658, 86th Cong., 1st Sess. 2-3 (1959).

18. *See, e.g.,* 105 CONG. REC. 14,554 (1959) (statement of Rep. Curtis).

19. *See, e.g., id.* at 16,353 (statement of Sen. Byrd): "The whole matter is in a state of confusion, and the judicial application of constitutional principles to State taxation leaves much room for controversy and confusion and little guide to the States in exercising their taxing power."

20. As stated previously, these decisions apparently allow a state to tax foreign corporations that solicit orders within the state even though the corporations maintain no permanent office or warehouse within the stata. *See supra* note 15 and accompanying text.

21. *See, e.g.,* 105 CONG. REC. 16,384 (1959) (statement of Sen. Kerr):

If [the holding of *Northwestern Cement*] is permitted to go unchallenged burden,[22] Congressmen articulated four arguments for adopting a legislative remedy.

First, expanded state taxation of interstate commerce would discriminate against small businesses vis-a-vis big businesses. Although discrimination inherently pervades state taxation of interstate commerce,[23] it was believed that "a continuation of the present situation unchecked by congressional action would present innumerable problems, including arbitrary and discriminatory enforcement; would make compliance extremely difficult, especially for businesses with diffused markets[; and] would compel many small and moderate-size businesses to give up selling in States because of uncertain tax liability."[24] Additionally, small businesses would be precluded from interstate commerce since they could not afford to file returns[25] and pay taxes[26] in each state where their merchandise was sold. However, larger businesses would still be able to utilize interstate markets because they could afford to file returns and pay taxes in similar situations. In fact, many large companies were already doing so in a great majority of states.[27] Thus, Congress sought a remedy

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> and unchanged, then whenever a farmer shipped his wheat to Kansas City, from a wheat-producing State, for sale by a commission company, the State in which the sale was consummated could levy an income tax on the profit the farmer made on the wheat.
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> . . . I believe that one of the rights of a State is the right of its citizens to sell their property in interstate commerce, and not be subject to the income-taxing powers of the State in which the property is sold.

22. These debates occurred between June and August of 1959. *See* 105 CONG. REC. 11,161-17,468 (1959).

23. *See, e.g.,* 105 CONG. REC. 16,479 (1959) (statement of Sen. Neuberger): "Economists have long pointed to the inequities inherent in State taxation of interstate commerce. Discrimination results from the great diversity as point of origin, destination, and sales penalizes some businesses and rewards others on the basis of location, markets, and selling practices."

24. *Id.* (quoting letter from Mr. William Blade, manager of Oregon Tax Research, discussing views of Dr. Paul Studenski, a New York University economist).

25. *See, e.g., id.* at 16,359 (statement of Sen. Talmadge):

> I believe that we need remedial legislation, to wipe out the apprehensions and fears as to what may happen. If a salesman goes into 50 States and solicits orders, the corporation or business may have to file income tax returns in 50 States. That ought not to be the law.

26. *See, e.g., id.* at 16,359 (statement of Sen. Saltonstall): "What [small businesses] cannot afford to do is to be taxed in all those States, as compared with a big business which, we might say, could afford to be taxed in those States, even though it might not desire to be taxed."

27. *See, e.g., id.* at 17,773 (statement of Rep. Miller) (indicating that a continuation of the current trend of state taxation of interstate commerce would only hurt small busi-

that would allow small businesses to compete effectively with large businesses in interstate commerce.[28]

Closely related to the preceding argument was Congress's second argument for a legislative remedy. It centered on concern over the *administrative* burden that state taxation would place on businesses engaged in interstate commerce.[29] Businesses would need to (1) file numerous tax returns based on a variety of state income allocation formulas; (2) retain separate tax counsel in each state; and (3) allocate sales between states (increasing accounting expenses). Additionally, the cost of state enforcement and small business compliance could well exceed the amount of tax collected.[30] Furthermore, a business could ultimately be taxed on more than 100% of its income,[31] arguably a form of prohibited double taxation.

A major portion of the cost of this increased administrative burden would be shouldered by the federal government because the expenses incurred to comply with state taxation would be deductible business expenses.[32] Any excess would probably be passed on to consumers in the form of higher prices. Yet, small businesses that could not afford these cash outlays would be forced to restrict their operations.

Congress's third argument was that the continuation of *Northwestern Cement* and subsequent decisions would leave open the Pandora's Box of uncertainties regarding a state's ability to tax corporations engaged in interstate commerce. Many businesses were in doubt about their tax liabilities and were hesitant to establish sales forces in other states. Businessmen strongly urged Congress to firmly and clearly define the limits of a state's ability to tax interstate commerce.[33] Congress recognized that any solution had to be uniformly applied[34] in order to achieve certainty and fairness.

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nesses because large businesses (*e.g.*, chain stores) were already subject to state taxation in many states).

28. *See, e.g., id.* at 16,354 (statement of Sen. Saltonstall).

29. *See, e.g., id.* at 16,467 (statement of Sen. Sparkman). For a summary of the burdens and special problems encountered by small businesses, see Note, *State Taxation of Interstate Commerce: Public Law 86-272*, 46 VA. L. REV. 297, 303-04 (1960).

30. Note, *supra* note 29, at 303.

31. *Id.*

32. I.R.C. § 164 (1982).

33. *See generally Hearings, Small Business Committee, supra* note 16.

34. *See, e.g.,* 105 CONG. REC. 16,388 (statement of Sen. Sparkman); *id.* at 17,837 (statement of Sen. Kuchel). Congress hoped that the states would eventually adopt a uniform income allocation and taxation formula.

Finally, many senators and representatives believed that the continuation of this trend would interfere with the long established principle of free trade in the United States.[35] Many businesses would simply not venture beyond their state lines because of increased administrative costs and a growing uncertainty in the business world. This result would substantially impede interstate commerce and free trade between the states.[36]

III. PUBLIC LAW 86-272: THE SOLUTION?

To cure the problems and uncertainties caused by *Northwestern Cement* and subsequent decisions, Congress hastily[37] enacted Public Law 86-272.[38] However, Public Law 86-272 was intended to be only "an interim solution designed to prevent the states from extending their income taxes beyond the particular factual situations presented in *Northwestern Cement*; at the same time Congress directed further inquiry[39] into the problems of state taxation."[40]

Public Law 86-272 is divided into four sections. The first section prohibits a state from taxing a company's income derived from interstate commerce provided that the company's only business activities within the state are the "solicitation of orders" for sales of "tangible personal property," that are sent "outside the State for approval or rejection." The "delivery" of the goods must also originate from a point outside the state.[41]

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35. *See id.* at 11,958 (statement of Sen. Saltonstall): "Our Founding Fathers created the United States of America as a free-trade territory, and through the Commerce Clause of the Constitution they tried to outlaw those impediments to commerce which had long plagued the Old World." *See also id.* at 16,481 (statement of Sen. Ervin): "The decisions of the Supreme Court in the Northwestern States Portland Cement Co. and the Stockham Valves and Fittings, Inc., cases thwart in large measure the purpose of the Founding Fathers to establish completely free trade among all of the States of the United States."

36. *See, e.g., id.* at 17,773 (statement of Rep. Miller): "So, because of this new Supreme Court decision many States now say, 'Ah, now, apparently according to this decision for the first time in the history of our country, we can impose these artificial barriers, tariff barriers in each of the 48 States, to interstate commerce!' "

37. One commentator termed the bill "a piece of hasty, hysteria legislation . . . pressured through the Congress by a highly organized and certainly skillfully handled group of trade organizations." Roland, *State Taxation of Interstate Income: A State Tax Administrator's Viewpoint*, in 12 THE TAX EXECUTIVE 35, 35 (1959).

38. *See infra* Appendix I.

39. *See* Act of Apr. 7, 1961, Pub. L. No. 87-17, 75 Stat. 41.

40. *See Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953, 1008 (1962).

41. 15 U.S.C. § 381(a) (1982).

The second section provides that when the corporation is incorporated in, domiciled in, or a resident of the taxing state, the provisions of Public Law 86-272 do not apply.[42] The third section dictates that if a company transacts business through an independent contractor—rather than an employee—the independent contractor may sell products, solicit orders, and maintain an office within the taxing state without subjecting the out-of-state company's income to taxation.[43] Finally, the fourth section defines the term "independent contractor."[44]

Although Public Law 86-272 was enacted to save businesses, the prohibitive costs associated with determining tax liability, filing returns, and paying taxes in several states,[45] have prevented the statute from accomplishing its goal. One reason for this failure has been the uncertainty surrounding the breadth of the statute's application by state courts. If state courts apply the statute narrowly, businesses may find themselves subject to taxation even though they intended to fall within the protection of Public Law 86-272.

For example, in *Olympia Brewing Co. v. Department of Revenue*,[46] Olympia's salesmen limited their activity within Oregon to soliciting orders for the purchase of beer. Since these orders were sent outside Oregon for approval and delivery, Olympia believed that it fell within Public Law 86-272's protection. However, the Oregon Supreme Court held that the mere presence of Olympia's beer kegs in Oregon for the purpose of dispensing beer constituted activities beyond solicitation of orders. The state was allowed to tax the income Olympia derived from the sale of beer in interstate commerce to customers in Oregon. Certainly, Olympia Brewing Co. did not expect to file returns and pay taxes in every state in which they sold kegs of beer.

Another reason for the statute's failure is the lack of uniform interpretation of key terms by state courts.[47] For example,

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42. *Id.* § 381(b).
43. *Id.* § 381(c).
44. *Id.* § 381(d).
45. *See supra* notes 25-31 and accompanying text.
46. 266 Or. 309, 511 P.2d 837 (1973), *cert. denied*, 415 U.S. 976 (1974).
47. *See, e.g.*, P. HARTMAN, *supra* note 3, § 9:10:

> Since Congress failed to provide any guidance as to the meaning of "solicitation of orders" and "delivery," the state courts, of necessity, had to grapple with the meaning of those terms. Thus [far] the Supreme Court of the United States has not really clarified these two crucial terms. Since the judiciary of each State has no litmus paper test for determining the meaning of these

compare New Jersey's interpretation of the term "solicitation of orders" with Pennsylvania's interpretation. In *Clairol, Inc. v. Kingsley*,[48] the New Jersey Superior Court concluded that Clairol's business activities within New Jersey exceeded the "solicitation of orders" language. Although Clairol had not maintained an office within New Jersey (the taxing state), the company's employees within New Jersey had supervised other employees, investigated customer complaints, driven automobiles furnished by Clairol, distributed promotional material, carried company samples, assisted in setting up displays, rotated customer inventories, and taken inventory on customer premises. The court stressed these activities in denying Clairol the protection of Public Law 86-272.

The Pennsylvania Supreme Court encountered a similar case in *United States Tobacco v. Commonwealth*.[49] In *United States Tobacco* the company (U.S. Tobacco) had not maintained an office within Pennsylvania (the taxing state). However, the company's Pennsylvania sales representatives had driven company-owned cars, informed customers of company promotions, carried and sold company samples, assisted and supervised display setup, and checked and rotated inventory. Although the New Jersey Superior Court in *Clairol* had decided that these activities exceeded the "solicitation of orders" language, the Pennsylvania Supreme Court in *United States Tobacco* concluded that these activities were within the "solicitation of orders" language of Public Law 86-272.[50]

Since state courts vary significantly on the interpretation of

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terms, varying interpretations could be expected. The result, ironically, has been a diversity of interpretations of a *federal* statute enacted to secure some semblance of certainty and uniformity in one area of taxation of multistate business.

As presently will appear from the cases, the state court decisions have wound a tortuous and serpentine path in defining "solicitation" and "delivery." They have veered from a liberal construction that permits a foreign seller to conduct many activities incidental to solicitation without sacrificing the protection of the statute, to a narrower interpretation that affords less protection to the out-of-state seller. Furthermore, this fluctuation in defining "solicitation" and "delivery," as will soon appear, has taken place within the same jurisdiction.

48. 109 N.J. Super. 22, 262 A.2d 213, *aff'd*, 57 N.J. 199, 270 A.2d 702 (1970), *appeal dismissed*, 402 U.S. 902 (1971).

49. 478 Pa. 125, 386 A.2d 471, *cert. denied*, 439 U.S. 880 (1978).

50. The dissent in *United States Tobacco* believed that the Court should have followed the *Clairol* decision and should have held that these activities extended beyond "solicitation of orders." *Id.* at 142, 386 A.2d at 479 (Roberts, J., dissenting).

key terms within Public Law 86-272, out-of-state companies still have apprehensions and doubts concerning state taxation in states that bave not yet interpreted Public Law 86-272. Furthermore, even if a particular state has interpreted Public Law 86-272 in the past, there is no guarantee that the state will continue to adhere to prior interpretations.

For example, analyze Oregon's treatment and interpretation of Public Law 86-272. In *Smith Kline & French Laboratories v. State Tax Commission*,[51] the Oregon Supreme Court held that certain activities of the taxpayer were protected by Public Law 86-272. These activities included maintaining a staff of resident "detailmen" who traversed the state promoting the sale and use of the taxpayer's products and maintained stocks of company-owned samples at their homes. Although the detailmen promoted the company's products, rarely did they actually solicit orders. In reaching the conclusion that the detailmen's activities did not exceed the "solicitation of orders" language, the court recognized that Congress intended to include all lesser promotional activities in the solicitation of orders exemption.

Later, the Oregon Supreme Court, in *Herff Jones Co. v. State Tax Commission*[52] and in *Olympia Brewing Co.*,[53] redefined "solicitation" so that *any* activity other than the actual solicitation of orders would cause an out-of-state company to lose the protection of Public Law 86-272. Thus, apprehension and doubts continue.

Public Law 86-272, as applied by the state courts, has failed to cure the problems that generated its enactment. Although the lack of uniform interpretation and application are partly to blame, the principal reason for the statute's failure is that it was never intended to completely rectify the problems associated with state taxation of interstate commerce.[54] Public Law 86-272

51. 241 Or. 50, 403 P.2d 375 (1965).

52. 247 Or. 404, 430 P.2d 998 (1967).

53. 266 Or. 309, 511 P.2d 837 (1973), *cert. denied*, 415 U.S. 976 (1974).

54. *See, e.g.*, 105 CONG. REC. 16,354 (1959) (statement of Sen. Byrd): "[Public Law 86-272] does not attempt to meet all of the problems which may arise in connection with State . . . taxation of interstate commerce." *See also* S. REP. No. 658, 86th Cong., 1st Sess. 4-5 (1959):

> Your committee 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

was only meant to provide a temporary solution[55] until a detailed study[56] could be conducted and recommendations made.[57] Although the study was made, none of the recommendations it generated, nor any similar legislation,[58] has yet been adopted.[59]

IV. The Proper Role and Interpretation of Public Law 86-272

Since neither Congress nor the Supreme Court has clarified the meaning of Public Law 86-272, in defining the nexus required for state taxation of interstate commerce, one must determine the proper interpretation and role of Public Law 86-272. The intent of Congress in enacting Public Law 86-272 is extremely relevant in resolving this issue.

A. *The Proper Role of Public Law 86-272: Congressional Intent*

In applying Public Law 86-272, many state courts have seemed to adopt an all-or-nothing approach. The court decides whether the activities of the out-of-state company are encompassed by the tax immunity granted in Public Law 86-272. If the

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serve as an effective stopgap or temporary solution while further studies are made of the problem.

55. *See, e.g.*, 105 Cong. Rec. 17,774 (1959) (statament of Rep. Whitener): "There are some features of this legislation that I do not feel meet the entire problem. This is, however, merely a temporary or stopgap measure, and we must do something now, I think, in the interest of the small businesses." *See also* S. Rep. No. 658, 86th Cong., 1st Sess. 4-5 (1959).

56. *See* S. Rep. No. 658, 86th Cong., 1st Sess. 4-5 (1959). The study was conducted between 1961 and 1965 by a special subcommittee on state taxation of interstate commerce. The results and recommendations of this study are set forth in a four volume report submitted to Congress in September 1965. *See* House Judiciary Comm., Special Subcomm. on State Taxation of Interstate Commerce, H.R. Rep. No. 952, 89th Cong., 1st Sess. (1965); H.R. Rep. No. 565, 89th Cong., 1st Sess. (1965) (Sales and Use Taxes, Capital Stock Taxes, and Gross Receipts Taxes); H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964) (Income Taxes).

57. The study found major defects in the area of state taxation of interstate commerce that were bad both for business and for the states. The Subcommittee recommended that Congress enact legislation substantially limiting the states' taxing power. H.R. Rep. No. 952, 89th Cong., 1st Sess. 4 (1965).

58. For a summary of some of the proposed bills, see Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 Vand. L. Rev. 335, 340-41 (1976).

59. State opposition is probably the reason why Congress has failed to adopt any of the recommendations. *See* P. Hartman, *supra* note 3, § 9:9, at 481 (citing Hellerstein, *State Taxation Under the Commerce Clause: An Historical Perspective*, 29 Vand. L. Rev. 335, 340 n.14 (1976)).

company's activities are not protected by the statute, state courts assume that the state has power to tax the company. This approach clearly violates the legislative intent behind Public Law 86-272.

Public Law 86-272 only attempted to define what minimum activities[60] would *not* be subject to state taxation.[61] The statute did "not give to the States any power to tax income derived from interstate commerce. The power of the States in this respect [should] be determined with no inference from [the] bill."[62] Senator Byrd, the sponsor of the original bill, aptly described the intent behind Public Law 86-272. He stated:

> There are some who fear that the bill will be construed by the States as giving them authority to tax income derived from interstate activities which do not fall within the immunity provisions of the bill. This is not the case. The bill does not give the States any power to tax income derived from interstate commerce. The power of the States in this respect will be determined with no inference from the bill. Whether business activities other than those described in the bill constitute a sufficient basis for the imposition by a State or political subdivision thereof of a net income tax on income derived from interstate commerce is left for future determination by the Congress, or in the absence of congressional action, by the courts.[63]

The preceding quotation indicates that if a company does not obtain immunity from state taxation through Public Law 86-272, the state may not automatically subject the company to taxation. Rather, the courts must decide, based on established federal and state case law,[64] whether the state can subject the

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60. The subtitle of the first section of 15 U.S.C. § 381 (1982) is entitled "Minimum Standards."

61. S. REP. No. 658, 86th Cong., 1st Sess. 2 (1959): "This approach may be referred to as a 'minimum activities' type of approach."

62. *Id.* at 5; *see also* 105 CONG. REC. 17,838 (1959) (statement of Sen. Byrd): "There is nothing which changes the present basis of taxation, except an immunity is given under certain conditions with regard to sales which come under the provisions of the bill."

63. 105 CONG. REC. 16,354 (1959) (statement of Sen. Byrd).

64. *See, e.g., id.* at 16,377 (statement of Sen. Javits):

> Therefore I believe this measure is a fair effort to meet that situation, because it sets only minimal standards.
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> Let us understand what that means. The language of the bill, on page 1, line 5, reads:
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> > A net income tax on income derived within such State if the only business activities within such State by or on behalf of such person during such taxable year are any, or all, of the following.

company's income derived from interstate commerce[65] to taxation.[66]

The established case law at present is contained in *Northwestern Cement* and *Stockham Valves.*[67] In essence, by enacting Public Law 86-272, Congress arguably codified the decision in *Northwestern Cement* and *Stockham Valves.* This conclusion is supported by congressional intent. Representative Walter stated, "The proposed legislation would in effect hold the taxing power

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> In short, if there are other business activities, they are still left within the realm of decided cases under State and Federal law, so far as the taxing power of the State is concerned. This is a very minimal standard, in order to insure that business may be conducted while a study takes place and more of these questions are resolved.
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> I point out that one of the major things which is not incorporated in this minimal standard is servicing and maintenance, which is a very essential element of operation in a particular State, and which calls upon the use of the State facilities in a way very different from the solicitation of orders.
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> So it must be emphasized, first, that the bill seeks to apply only a minimal, and not a maximal, standard, and that there is an enormous range of factual situations between the minimal standards set by the bill and the maximal, involving the direct taxing power of the State.
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> . . . .
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> It seems to me that what we are doing in connection with this particular measure is minimizing the area of conflict by setting certain very basic minimal standards which we, as a legislature, will construe as not representing doing business within a State.

65. Although this article discusses state taxation of interstate commerce, some observers have commented that the issue is whether certain transactions involve interstate or intrastate commerce. *See, e.g.,* 105 CONG. REC. 16,475 (1959) (statement of Sen. Cooper):

> We start out with the first principle that a State cannot lay a burden upon business which is exclusively in interstate commerce. If the imposition of State taxes has been affirmed from time to time, it has been because it has found that a part of interstate commerce is peculiarly intrastate.

See also id. at 17,771 (statement of Rep. Walter):

> Mr. Speaker, I think the reason for the need of this legislation is important. As you will recall, the Supreme Court of the United States handed down a decision which seemed to indicate a power to tax interstate commerce, which power did not exist, does not exist, and nobody has ever contended that the power did exist.

66. See P. HARTMAN, *supra* note 3, § 9:9, in which Mr. Hartman writes, "The statute is written as a limitation on state power, and it does not undertake to define affirmatively the activities which create liability. As a result, in areas not covered by the statute, the issue of the power of the States to tax remains a question for the courts."

67. *See, e.g.,* 105 CONG. REC. 17,771 (1959) (statement of Rep. Walter):

> I might say to my distinguished friend from Texas that nobody is disposed to indicate what kind of taxes may or may not be levied. That is something that is not considered in this legislation. All we do is endeavor to convince the small business people in America that the law, as they thought it was prior to the denials of certiorari in the Brown-Forman and International Shoe cases, is still the law.

of the several States to the exact situation passed on by the Court only until Congress has a chance to examine into the whole question and enact permanent corrective legislation."[68] Many other congressmen also indicated that Public Law 86-272 was enacted to maintain the status quo: the law as recited in *Northwestern Cement* and *Stockham Valves*.[69]

B. *The Proper Interpretation of Public Law 86-272: The Required Nexus*

As discussed above, Public Law 86-272 was enacted to remedy the problems and calm the worries of small businesses caused by the denials of certiorari in the *Brown-Forman* and *International Shoe* decisions.[70] Public Law 86-272 also arguably codified the results of the *Northwestern Cement* and *Stockham Valves* decisions.[71] In order to determine whether a company engaging in interstate commerce may be subjected to state taxation, it would be helpful to compare the factual circumstances in the *Northwestern Cement* and *Stockham Valves* cases (where Congress would allow taxation) with those in the *Brown-Forman* and *International Shoe* cases (where Congress would not allow

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68. *Id.* at 12,903 (statement of Rep. Walter).

69. *See, e.g., id.* at 16,477 (statement of Sen. Carlson): "Therefore I urge that the Senate take that action, in order that we may complete action on legislation, which I think we need, to hold the situation in status quo until the Congress meets next year." *See also id.* at 16,359, in which Sen. Saltonstall stated:

> As I see it, the purpose of the proposed legislation is to quiet the apprehensions of the small businessmen particularly, as the Senator from Georgia says, as well as the big businessmen, as to what they are likely to encounter. What we wish to do is to make it clear that the law should remain in status quo until a commission or committee considers the question of changing the statutes.

Furthermore, Sen. Sparkman added: "I am seeking to hold the definition to that given by the Supreme Court, until a study can be made of all the implications and complications of this problem in the hope that the States may be able to arrive at some kind of uniform program." *Id.* at 16,388. Finally, Sen. McCulloch commented: "It is my studied judgment that this conference committee report when it becomes law, in effect will in substance, restate that which we all thought was the law up until this time." *Id.* at 17,772.

The confusion and outcry of small businesses started after the *Brown-Forman* and *International Shoe* decisions. To remedy this confusion, Congress enacted Public Law 86-272 which prohibited state taxation in factual circumstances similar to those found in *Brown-Forman* and *International Shoe*. In essence, by making *Northwestern Cement* and *Stockham Valves* the relevant law, Congress stepped back from the *Brown-Forman* and *International Shoe* decisions.

70. *See supra* note 67.

71. *See supra* notes 67-69.

taxation).[72] This comparison will highlight the relevant factors in determining the nexus required before a state may tax an out-of-state corporation on its income derived from interstate commerce.

The factual circumstances in the *Northwestern Cement* and *Stockham Valves* cases were similar. In both cases, salesmen regularly and systematically solicited orders that were sent outside the state to be approved and filled. In each case, the company also maintained a sales office within the taxing state.[73] In *Brown-Forman*, the only connection between the taxpayer (company) and the taxing state was the presence of "missionary men" who neither solicited nor accepted orders. Their activities consisted of relaying orders from wholesalers to company headquarters for approval and assisting some of the wholesalers in setting up displays. The company did not maintain any office within the taxing state. Likewise, the out-of-state company in *International Shoe* had no permanent office in the taxing state. However, the company did have fifteen salesmen within the state who systematically solicited orders that were approved and filled from a neighboring state.

The only material factual difference between the *Northwestern Cement* and *Stockham Valves* cases and the *Brown-Forman* and *International Shoe* cases is the maintenance of a sales office by the out-of-state corporations in the former cases.[74] Since Congress intended out-of-state companies to be taxed

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72. This comparison is necessary because Public Law 86-272, although designed as a temporary solution, has become a permanent solution through Congress's inaction. *See supra* notes 54-59.

73. Notice the similarity between these factual patterns and Public Law 86-272's requirements for tax immunity. Public Law 86-272 allows immunity when there is a systematic solicitation of orders, sent outside the state for approval, and filled by shipment or delivery from a point outside the state. However, the maintenance of a permanent sales office would cause the loss of such immunity. Since Congress intended Public Law 86-272 to codify the results in *Northwestern Cement* and *Stockham Valves*, Congress must have intended the maintenance of a permanent sales office to be a key factor in allowing state taxation; however, the exact terms of the statute would allow immunity if the out-of-state companies in *Northwestern Cement* and *Stockham Valves* had not maintained a sales office.

74. In *Northwestern Cement*, *Stockham Valves*, and *International Shoe*, salesmen solicited orders that were approved outside the state. The delivery of the merchandise also originated outside the state. In *Brown-Forman*, the company's "missionary men" did not solicit orders, but they did relay orders for approval and delivery from outside the taxing state. In all four cases, company representatives engaged in what could be termed "activities incidental to solicitation." The only material distinction between the two sets of cases is the maintenance of an instate sales office by the taxpayer.

under the facts of *Northwestern Cement* and *Stockham Valves* but not under the facts of *Brown-Forman* and *International Shoe*, they must have intended the maintenance of an office to be the key criteria in determining whether a state may tax income derived from interstate commerce.

This conclusion is supported by the legislative history surrounding the enactment of Public Law 86-272. In describing a suggested solution to the problems created by the denials of certiorari in the *Brown-Forman* and *International Shoe* cases, Representative Walter remarked: "[I]t has been proposed that Congress enact legislation restricting state tax jurisdiction to situations where the corporation has a permanent establishment in the form of a plant, warehouse, stock of goods or office in the taxing state."[75] Later, in the Senate debates, Senator Byrd suggested that the states would not have the right to tax an out-of-state company "without any physical property being involved, and without the existence of any storehouse or warehouse or any other physical facilities."[76]

In fact, the original bill, as reported out of the Senate Finance Committee, contained an exemption for offices used for the "primary purpose" of serving company "representatives" in the "solicitation of orders."[77] However, this section was deleted from the bill[78] because, as Senator Talmadge indicated, an office had been a sufficient nexus for allowing a state to tax the income of foreign corporations.[79] Congress specifically suggested that "[a] strict reading of the Northwestern and Stockham cases indicates that those cases are authority only for the proposition that a tax may be imposed when the out-of-State business main-

75. 105 CONG. REC. 12,902 (1959).

76. *Id.* at 16,534.

77. *See id.* at 16,470.

78. *See id.* 16,477. The provision was deleted from the bill by a sixty-five to twenty-nine vote.

79. *See id.* at 16,470 (statement of Sen. Talmadge):

> In my judgment we need legislation, but the proposed legislation which has been reported by the Senate Finance Committee goes far beyond the bounds of legislation needed to correct the Supreme Court decisions.
>
> Why do I say that? Because historically the States of this Union have been permitted to tax the income of foreign corporations, provided there was a sufficient nexus with the State to tax such corporations.
>
> What has that nexus been? It has been defined by the Court time after time. That nexus has been an office, an agency, a warehouse, or a stock of salable goods within the State.

See also id. at 16,359, 16,475 (statement of Sen. Talmadge).

tains at least an office or other fixed business activity within the taxing State."[80]

Why should the maintenance of an office or other fixed business activity be the nexus required before allowing state taxation of interstate commerce? Senator Keating summarized the most convincing rationale:

> I believe that such a concept is equitable. A corporation which employs capital and labor and operates facilities within a State is an integral part of that State's economy and receives a variety of protective and other services for which the State should be compensated. Since these services directly relate to the income-producing activities of the company, a tax on income allocated to these activities is reasonable.
>
> On the other hand, a company which does not have a place of business in a State does not receive any benefits from the State which relate to its income-producing activities. Such a State does not put out a fire on the company's premises, it does not insure its employees against injury on the job, it does not protect its warehouses, it does not maintain the streets and highways or subways and utilities needed for the company's functioning. It provides nothing which would justify the exaction of an income tax from out-of-State firms.[81]

Some may argue that a company receives benefits from a state even though the company maintains no office or permanent domicile in the state.[82] However, these benefits are also received by companies that fall within the tax immunity granted by Public Law 86-272. Since exempt companies are not required to pay for these "benefits received," companies that do not maintain an office should not be required to pay either.

A company that maintains an office in the taxing state receives from the state substantially more benefits than a company that merely sends salesmen into the state. For example, the company with an office in the taxing state receives police

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80. H.R. Rep. No. 936, 86th Cong., 1st Sess. 1 (1959), *reprinted in* 105 Cong. Rec. 16,470 (1959) at request of Sen. Talmadge.

81. 105 Cong. Rec. 16,362 (1959).

82. *See, e.g., id.* at 16,366 (statement of Sen. Gruening):

> When the salesman comes to the consuming State from the producing State, he is provided with all the usual State and local public services—police protection, for example. These services the States must provide even though he maintains no permanent domicile in the State and is transient. The costs of these services must be paid, and the State must obtain the funds therefor from some of the very businesses located in the State with which the salesman's concern is competing.

and fire protection for its office and employees. The company has an established place of business, maintains a commercial phone listing, and generally holds itself out as doing business within the state at all times. A company that maintains an office or other permanent presence in the taxing state should, therefore, be subject to taxation.[83] Companies that do not maintain a permanent presence should not be subject to taxation. The interpretation of Public Law 86-272 by state courts should correspond with this analysis.

C. *Interpreting "Solicitation of Orders:" The Negotiations Issue*

Does the protection of Public Law 86-272 extend to out-of-state companies whose only contact with a state is the *negotiation* of a sales contract within the state's boundaries? In other words, does the "solicitation of orders" language of Public Law 86-272 encompass negotiations surrounding the order?[84]

Public Law 86-272 protects solicitation of orders. An order is an offer to buy specific goods under specific terms. The terms of an order, however, must often be negotiated before the order is sent outside the state for "approval." For example, complex interstate commercial transactions often involve millions of dol-

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83. A problem may arise, however, when one attempts to determine what constitutes an office or permanent presence. For example, does a hotel room constitute an office when occupied by employees of an out-of-state company? If the hotel room is recognized in the community as the company's place of business, i.e., the company maintains a commercial address, phone listing, or stores inventory in the hotel room, then the company would be receiving the same benefits a company that maintains or leases a commercial office within the taxing state receives. Therefore, the company should be taxed. On the other hand, if the hotel room is used only as living quarters for the company's sales people, the company should not be subject to taxation.

84. Although no case seems to deal directly with the negotiations issue, the author believes, based on discussions with taxing authorities of the state of California, that the issue is relevant.

To illustrate, assume Company A, a California corporation, wants to purchase an airplane from Company B, another California corporation. Company A however, cannot arrange financing because of a poor credit record. Company C, an out-of-state corporation, offers to purchase the plane from Company B and immediately sell it on credit to Company A. Company C and Company A, who must negotiate the terms of the sale (price, interest rate, maturity, etc.), decide to conduct sale negotiations in California.

Even if we assume that final approval and delivery occurs outside California, the California taxing authorities have indicated they would attempt to enforce a tax on the income that Company C would earn from the transaction. The taxing authorities believe that the power to negotiate in the preceding example would be equivalent to a power to bind. Therefore, the negotiators would be treated as having made the sale within California.

lars and require the parties to negotiate many terms including payment, delivery, insurance, bonding, guarantees, warranties, price discounts, etc. Thus, in many instances, negotiations are inherently involved in the solicitation of orders process.

If the protection of Public Law 86-272 were not extended to negotiations connected with solicitation of orders, discrimination in favor of businesses that sell standard products at standard prices would occur. Congress could not have intended Public Law 86-272 to produce such discriminatory results. A company that negotiates sales terms within the state should not be taxed on the income generated from the transaction when companies that systematically solicit orders for standard merchandise under inflexible terms are not similarly taxed. No rational basis exists for such a distinction.[85] Consequently, in protecting solicitation of orders, Public Law 86-272 should also logically protect negotiations connected therewith.

Additionally, the protection granted to solicitation of orders should extend to negotiations because state authorities would have great difficulty scrutinizing each transaction between in-state and out-of-state companies to determine whether negotiations were conducted or if orders were approved automatically.

On the other hand, some may contend that the power to negotiate is equivalent to the power to approve a sale within the state. By negotiating all the terms of an order, the salesman arguably approves the order within the taxing state at the time negotiations are completed. The order is sent to the home office merely for rote approval. Thus, the out-of-state corporation should be taxed on the income derived from the transaction.

However, rote approval also results when companies automatically approve orders for standard products sold at standard prices. No one has suggested that such rote approval ought to cause these companies to lose protection of Public Law 86-272.

Despite the clear distinction between rote and substantive approval, Public Law 86-272 does not distinguish between the two. The standard or suggested nexus discussed in this article illustrates that such a distinction is irrelevant. The maintenance of an office or warehouse in the taxing state should be the nexus required before a state can tax the income derived from inter-

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85. Even if such a rationale existed, out-of-state companies could still avoid state taxation by either negotiating the transaction in another state or eliminating the need to negotiate altogether by listing thousands of permutations of possible acceptable terms.

state commerce. Under this standard, unless the out-of-state company maintained an office or warehouse within the taxing state, negotiations would be protected under Public Law 86-272.

D. Interpreting the Independent Contractor Exemption

Public Law 86-272 protects an out-of-state company from being taxed when the company makes sales through independent contractors within the taxing state. Theoretically, the rationale behind this protection must be that an independent contractor who receives a fee for his services is subject to state taxation on that income. The independent contractor's tax payment for benefits received from the state relieves the out-of-state company from taxation.

More specifically, Public Law 86-272 provides that sales[86] of tangible personal property, solicitation of orders for sales, or maintenance of an office in the taxing state will not subject an out-of-state corporation to state income taxation if such activities are conducted by an independent contractor.[87] For purposes of the statute, an independent contractor is a "commission agent, or broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities."[88] Since this definition embodies the very word being defined, the definition may, at first glance, seem circular.

As of 1982, only the Oregon Supreme Court in *Herff Jones Co. v. State Tax Commission*[89] and the Minnesota Supreme Court in *Tonka Corp. v. Commissioner of Taxation*[90] had dealt with this interpretative difficulty. Botb courts found Public Law 86-272's definition of "independent contractor" to be ambiguous; consequently, the courts looked to their own state's case law to help define the term.[91]

In *Herff Jones*, the Oregon court concluded that under local law, "[t]he single most important factor in determining whether an individual is an independent contractor or a servant

86. The word "sales" is a term of art referring to approval of orders within the taxing state. *See* 105 CONG. REC. 17,834 (1959) (statements of Sen.'s Byrd and Javits).

87. 15 U.S.C. § 381(c) (1982).

88. *Id.* § 381(d)(1).

89. 247 Or. 404, 430 P.2d 998 (1967).

90. 284 Minn. 185, 169 N.W.2d 589 (1969).

91. 247 Or. at 409, 430 P.2d at 1000; 284 Minn. at 191-93, 169 N.W.2d at 593-94.

is the right to control or interfere with the manner and method of accomplishing the result—not the actual exercise of control."[92] Likewise, the Minnesota court in *Tonka* noted that the right to exercise control is the key factor in deciding whether an individual is an independent contractor or an agent.[93] In both cases, each court emphasized the out-of-state company's right to control the activities of its sales people. Since the company had the right to control, the sales people were deemed representatives rather than independent contractors.

The Oregon and Minnesota courts should not have looked to local law as the determining factor in deciding whether a corporation was entitled to the independent contractor exemption of Public Law 86-272; the federal statute's definition of independent contractor, while seemingly ambiguous, is sufficient. Public Law 86-272 defines the term independent contractor, for *purposes of the statute*, as including commission agents, brokers, and other independent contractors.[94] The term "independent contractor," as used in the statute, includes not only an independent contractor as defined by local law, but also commission agents and brokers—who may or may not be independent contractors[95] under local law.[96] Since the statute's definition in-

92. 247 Or. at 409, 430 P.2d at 1000.

93. 284 Minn. at 191, 169 N.W.2d at 593.

94. 15 U.S.C. § 381(d) (1982).

95. One could argue that the phrase "or other independent contractor" implies that a commission agent or broker must also be an independent contractor under local law. However, to satisfy the independent contractor definition with respect to commission agents or brokers, and thereby avoid taxation through the "independent contractor" exemption of Public Law 86-272, a company would be required to forfeit the right to control its commission agents or brokers. This ought not be required.

Public Law 86-272's language, on its face, actually determines whether an individual is doing business for himself or for the out-of-state company. If a commission agent or broker represents other principals in a similar sales capacity and holds himself out as an independent contractor in the normal course of his business (as required by the definition) he is transacting business for himself. If he only represents the out-of-state company or fails to hold himself out as available to other principals in the normal course of his business, he is transacting the company's business within the state. The company's right to control the commission agent or broker need not be emphasized in these situations. Nor should the commission agent or broker be required to be an independent contractor under state law.

Nevertheless, even if the language "or other independent contractor" requires commission agents and brokers to be independent contractors, the right to control the activities of an individual is only one factor in determining an independent contractor relationship. Other factors are also important. For example, see Housewright v. Pacific Far East Line, 229 Cal. App. 2d Supp. 259, 40 Cal. Rptr. 208 (1964), in which the court discusses other relevant factors, such as, whether the services performed are part of a distinct occupation or business and whether the parties believe they are creating the cludes more than common law independent contractors,[97] the courts in *Herff Jones* and *Tonka* erred when they considered only the definition of an independent contractor under local law.[98]

The Oregon and Minnesota courts also erred in concentrating solely on the "right to control" test. In the definition section of Public Law 86-272,[99] Congress had to clearly distinguish between a representative, who could only solicit orders in the taxing state,[100] and an independent contractor, who could solicit orders, consummate sales, and maintain an office in the taxing state without subjecting the out-of-state company to taxation.[101] In doing so, Congress focused more on the actual conduct or activities of the out-of-state company's sales people rather than on the relationship between the parties.[102] This focus is apparent from the definition itself, which reads in pertinent part, "the term 'independent contractor' means a commission agent, broker, or other independent contractor who is engaged in selling or soliciting orders . . . for more than one principal and who holds

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relationship of employer-employee. *Id.* at 266, 40 Cal. Rptr. at 212-13. When an individual represents many principals in the normal course of his business activities, his services are obviously part of a distinct business and neither party believes that they are creating an employer-employee relationship.

96. For example, a salesperson who would be an independent contractor under state law would also be an independent contractor for purposes of Public Law 86-272. However, a commission agent who would not be an independent contractor under state law could be an independent contractor for purposes of Public Law 86-272.

97. A commission agent may not be a common-law independent contractor because his principal has the right to control the details of his sales work. After all, agency is defined as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." RESTATEMENT (SECOND) OF AGENCY § 1 (1957). However, as long as he works for "more than one principal" and "holds himself out as such in the regular course of his business activities," he will be deemed an independent contractor for purposes of Public Law 86-272.

98. Alternatively, one could argue that the courts should have looked to federal law, if any, in defining terms within a federal statute. *See, e.g.*, Clearfield Trust Co. v. United States, 318 U.S. 363 (1943).

99. 15 U.S.C. § 381(d).

100. *Id.* § 381(a).

101. *Id.* § 381(c).

102. Congress could have emphasized the right to control the details of a sales representative's work as the key factor in determining whether an individual was a company representative or an independent contractor. Instead, Congress gave greater weight to the sales representative's actual conduct. *See, e.g.*, 105 CONG. REC. 16,493 (1959) (statement of Sen. Gore indicating that a company could employ several salesmen within a state and avoid state taxation by qualifying the salesmen as independent contractors through their representing some other small concern).

himself out as such in the regular course of his business activities."[103] In order to satisfy the definition of an independent contractor, a sales representative must engage in similar sales activities for other principals.[104] He also must hold himself out as being available to represent others in the normal course of his business.[105] Thus, day-to-day conduct of the sales representative should be the determining factor in deciding whether the sales representative qualifies as an independent contractor.

In addition to the statute's language indicating that a functional or activities approach is the correct test, the same conclusion is reached by analogizing to the Internal Revenue Code (the "Code"). Under the Code a foreign corporation or nonresident alien individual is taxed on income earned from an agent's activities in the United States only if an office or other fixed place of business is maintained within the United States.[106] However, an independent agent is allowed to maintain an office without subjecting the foreign corporation or nonresident alien individual to

103. 15 U.S.C. § 381(d)(1) (1982).

104. One could argue that Public Law 86-272's language "engaged in selling, or soliciting orders . . . for more than one principal and who holds himself out as such in the regular course of his business activities" modifies only the term independent contractor and not commission agent or broker. In other words, *all brokers* and *all agents*, regardless of any sales efforts for other principals would qualify as independent contractors.

Although this argument makes sense grammatically because of the absence of a comma after the words, "other independent contractor," Congress could not have intended such a result. Adopting the preceding interpretation would undermine the whole statute since a company could easily achieve complete immunity by contractually establishing all sales representatives as commissioned agents or brokers. As independent contractors, the agents and brokers could then make sales and maintain offices without subjecting the out-of-state company's income to in-state taxation.

105. The definition also requires that the sales people be commission agents, brokers, or other independent contractors. As previously mentioned, a company can easily circumvent this requirement through contracts with its salesmen. *See supra* note 104. The contract could leave control of the work details to the salesmen, thereby qualifying the salesmen as independent contractors under local law. The contract could also be written so that the salesmen would be operating as commissioned agents or brokers. Since these relationships can easily be varied, Congress placed more emphasis on the activities of the salesmen. Generally, a person would qualify as an independent contractor for purposes of Public Law 86-272 only if he actually is in the business of representing many companies in their sales efforts (e.g., a professional manufacturers representative).

106. I.R.C. § 864(c)(4)(B) (1982). In other words, the nexus for taxation at the federal level is the maintenance of an office or fixed place of business within the United States. As discussed previously, this same nexus should be required for taxation at the state level.

a United States tax.[107] For purposes of taxing the foreign corporation, the term "independent agent" is defined as follows:

> [T]he term "independent agent" means a general commission agent, broker, or other agent of an independent status acting in the ordinary course of his business in that capacity. Thus, for example, an agent who, in pursuance of his usual trade or business, and for compensation, sells goods or merchandise consigned or entrusted to his possession, management, and control for that purpose by or for the owner of such goods or merchandise is an independent agent.[108]

Clearly the preceding definition adopts an activities approach rather than a relationship approach. The definition simply does not state that an agent must have independent status in a relationship sense. Therefore, in the area of foreign corporations and nonresident aliens, an agent achieves independent status through his activities rather than his relationships.[109] Since the language used to define an independent contractor for purposes of Public Law 86-272 and that used to define an independent agent for purposes of federal taxation are remarkably similar, they should receive similar interpretations. Both focus on an activities approach rather than a relationship approach and should be interpreted as such.

The conclusion that the courts in *Herff Jones* and in *Tonka* erred when they emphasized a relationship test (right to control) rather than an activities test is supported by one final argument. Suppose an out-of-state company transacts business within the taxing state through a wholly-owned subsidiary. In addition to selling products through the subsidiary, the parent also sells company products through other brokers within the taxing state. All of the dealings between the parent and the subsidiary are conducted at arm's length, and the subsidiary acts as a broker in other transactions for other principals. Based on these facts, the

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107. I.R.C. § 864(c)(5)(A)(ii) (1982). Note that Public Law 86-272 also allows an independent contractor to maintain an office without subjecting the out-of-state corporation to a state tax.

108. Treas. Reg. § 1.864-7(d)(3)(i) (1972). Once again, notice the similarity between the Treasury Regulation's definition of independent agent and Public Law 86-272's definition of independent contractor.

109. Treas. Reg. § 1.864-7(d)(3)(ii) (1972) illustrates this point in the following example: "For example, a wholly-owned domestic subsidiary corporation [subject to the foreign parent's control] or a foreign corporation which acts as an agent for the foreign parent corporation may be treated as acting in the capacity of independent agent for the foreign parent corporation."

subsidiary should qualify as an independent contractor for purposes of Public Law 86-272.[110] After all, the subsidiary is acting as a broker, representing other principals, and holding itself out in its regular course of business as available to represent other principals. Since the subsidiary would pay taxes on the benefits it receives, the out-of-state parent should not pay taxes also.

However, according to the rationale in *Herff Jones* and *Tonka*, the subsidiary would not qualify as an independent contractor for purposes of Public Law 86-272 and the parent corporation would be subject to taxation. The subsidiary arguably fails the right to control or relationship test because the parent has the right to control the subsidiary's actions. Nevertheless, as illustrated above and emphasized by Senator Gore,[111] the subsidiary should logically be treated as an independent contractor under the terms of the definition.

Finally, the approach advocated in *Herff Jones* and *Tonka* undermines the most logical explanation for why Congress chose its definition of an independent contractor. Congress was apparently trying to prevent an out-of-state company from establishing all of its sales people as independent contractors in order to avoid state taxation. By requiring individuals in the normal course of their business to represent other principals before independent contractor status attaches, Congress made it more difficult for a company to circumvent state taxation. An individual would have a much more difficult time qualifying as an independent contractor under an activities approach than under a right to control approach.

In summary, an activities approach, although not advocated in *Herff Jones* and *Tonka*, should be the approach taken by future courts to determine whether an individual is an independent contractor. The statute's language, similar language in the

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110. See 105 CONG. REC. 16,495 (1959) for the following discussion:

Mr. GORE. I read the definition and found it very interesting. Would it not be possible for a subsidiary corporation to act as, or to be, an independent contractor under the terms of the definition?

Mr. BYRD of Virginia. Mr. Stam says he does not think it would be possible.

Mr. GORE. I do not know upon what Mr. Stam bases his judgment.

Mr. BYRD of Virginia. If that were done, the subsidiary would be subject to the taxes of the State in which it resided.

111. *Id.* The comment by Senator Byrd is pertinent. Taxing the subsidiary requires payment for benefits received. The out-of-state parent should not also have to pay or be subject to taxation for benefits received.

Internal Revenue Code, and congressional motives mandate such a course of action.

V. Recommended Solution

Problems caused by the varied interpretations of Public Law 86-272 could be resolved by at least two means. First, courts could adopt the interpretation of Public Law 86-272 advocated within this article. Second, Public Law 86-272 could be revised to more properly correspond with the legislative intent behind its enactment.

A. Adopting a Uniform Interpretation of the Current Statute

If state courts uniformly interpreted Public Law 86-272, in the manner specified in this article, then many of the uncertainties and problems created by past decisions could be avoided in the future. Public Law 86-272 would prohibit taxation of an out-of-state company when its salesmen only solicited orders within the taxing state. In other circumstances the *Northwestern Cement* and *Stockham Valves* cases would be applied by the courts to determine whether an out-of-state company could be taxed. As illustrated in this article, the required nexus for taxation in these other circumstances should be the maintenance of a permanent office or warehouse within the taxing state.[112]

State courts have not yet achieved or even attempted uniformity in their interpretation of Public Law 86-272.[113] Although the United States Supreme Court could provide guidance concerning the proper uniform interpretation of the statute, it has been reluctant to review the cases presenting the issues. Congress could also provide interpretative guidance. However, rather than establishing interpretative guidelines, Congress could best serve all interests involved by revising the statute.

B. Revising the Statute

A revision of the current statute would help clear up the problems and uncertainties caused by the present statute. An example is presented below. Like the current statute, the sug-

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112. *See supra* notes 70-83 and accompanying text.
113. *See supra* note 47.

gested statute prohibits state taxation when the out-of-state company complies with the limits prescribed by the statute.

Suggested Statute

§ 381. Imposition of Net Income Tax

(a) Taxing Standards

No state, or political subdivision thereof, shall have the power to impose, for any taxable year ending after [date of revision], a net income tax on the income derived within such state by any person from interstate commerce unless the business activities within such state in connection with the sale of tangible personal property by or on behalf of such person during such taxable year include:

(1) the maintenance of an office or warehouse; or

(2) the maintenance of fixed business activity.

(b) Domestic Corporations; Persons Domiciled in or Residents of a State

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any state, or political subdivision thereof, with respect to—

(1) any corporation that is incorporated under the laws of such state; or

(2) any individual who under the laws of such state, is domiciled in, or a resident of, such state.

(c) Sales or Solicitation of Orders for Sales by Independent Contractors

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a state during any taxable year merely by reason of sales in such state of tangible personal property on behalf of such person or by reason of the maintenance of an office, warehouse, or fixed business activity is such state by one or more independent contractors whose activities on behalf of such person in such state consist solely of making sales, or soliciting orders for sales of tangible personal property.

(d) Definitions

For purposes of this section—

(1) a person maintains an "office" within a state to the extent such person owns or leases real or personal property which is used or recognized in the community as the person's place of business;

(2) a person maintains a "warehouse" within a state to the extent such person owns tangible personal

> property which is located and held for resale within such state;
>
> (3) a person maintains "fixed business activity" within a state to the extent such person employs a representative who expends greater than one-half of his sales efforts for such person within the state; nevertheless, a person does not maintain "fixed business activity" within a state to the extent such person employs fewer than four representatives within the state whose gross sales for such person for the year total less than $200,000;
>
> (4) the term "independent contractor" means a person who is engaged in selling or soliciting orders for the sale of tangible personal property for more than one principal, who holds himself out as such in the regular course of his business activities, and who deals with each principal in an arm's length fashion;
>
> (5) the term "representative" does not include an independent contractor.

The sample statute differs substantially from the current statute. Part (a), rather than emphasizing solicitation of orders, disallows state taxation unless the out-of-state company maintains an office, warehouse, or fixed business activity. For purposes of the statute, an office is defined in part (d)(1) as real or personal property that is used or recognized in the community as the out-of-state company's place of business and is owned or leased by the company.

The "real or personal property" language prevents circumvention of the statute through the establishment of an office within personal property such as a mobile home. The "owned or leased" language prevents circumvention of the statute by leasing an office rather than owning one. Finally, the language "used or recognized in the community as the person's place of business" is important in two respects. First, the language protects an out-of-state company from taxation when the company's salesmen are provided company-owned cars but no offices within the state, or when the company rents a room to negotiate an isolated transaction. Second, the language prevents circumvention of the statute by an out-of-state company that rents a hotel room under the guise of providing temporary living quarters for its representatives. If the living quarters are commonly recognized as the out-of-state company's place of business, the company would be treated as actually maintaining an office within the state and would be subject to the state's income tax.

The second half of part (a)(1) disallows state taxation unless the out-of-state company maintains a warehouse. The definition of warehouse in the sample statute's part (d)(2), in conjunction with part (a), subjects the out-of-state company to state taxation when the company has personal property located or held for resale within the taxing state. When an out-of-state company stores goods which are held for resale within a state, the company receives substantial benefits from the state including, but not limited to, protection against theft. The out-of-state company should pay for these benefits.

Part (a)(2), which disallows taxation unless the out-of-state company maintains "fixed business activity" within the state, is added to protect against circumvention of the statute. For example, part (a)(1) disallows state taxation unless the out-of-state company maintains an office. However, suppose a company representative leases an office under his name but transacts business solely for an out-of-state company within the state during the entire year. Arguably, by compensating the representative for his payment of the rent, the out-of-state company is the true entity maintaining the office.

Determining the true lessee in the preceding example could be a difficult question. However, part (a)(2), in conjunction with the definition of the term "fixed business activity" provided in part (d)(3), eliminates the need for this difficult factual determination. The statute provides that when a representative expends greater than one-half of his sales efforts within the state for the out-of-state company, the company is subject to taxation by the state.

Part (a)(2) also prevents an out-of-state company from circumventing state taxation when it employs a representative who lives and works full time within a state for the company but who works without any official office. Arguably, the out-of-state company is receiving substantial benefits from the state for which the company should pay. Indeed, a representative who works full time for the company may become a substitute office. People learn to call the individual in order to transact business with the out-of-state company. In fact, the representative's home could possibly fall within the definition of an office, if owned or leased by the out-of-state company. As stated previously, part (a)(2), in conjunction with the definition provided in part (d)(3), protects against such manipulation.

Although part (a)(2)'s grasp is potentially quite broad, an exception exists for activities carried out on a relatively small scale. For example, consider test marketing. Suppose a company has a new product that it would like to market in a neighboring state. The company may have difficulty in finding an independent contractor who will sell the company's products. Additionally, the company may not want to hire a salesman and pay his traveling expenses. Therefore, the out-of-state company hires a person living in the taxing state to work on a part-time basis. Since this person expends all his sales efforts for the small company within the state, the company would be engaged in fixed business activity within the state and would be subject to taxation. However, part (d)(3) exempts activity to the extent that the out-of-state company employs fewer than four representatives whose combined sales for the company within the state for the year total less than $200,000.

Thus, the proposed statute would not prevent small companies from expanding their operations into other states. As long as companies transact business through representatives who expend less than one-half of their sales efforts in the new state or who meet the requirements for the part (d)(3) exemption, the companies will not be subject to taxation by the state (provided the companies do not maintain an office or warehouse within the state). Furthermore, out-of-state companies could still avoid taxation by operating through independent contractors in the new state.

The final difference embodied in the suggested statute relates to the definition of the term "independent contractor." The sample statute eliminates any relationship requirement by deleting the words "commission agent, broker, or other independent contractor" and substituting the word "person." Hopefully, this change will eliminate the confusion behind the interpretation of this term.

The relationship between an individual and the out-of-state principal should not determine whether an individual is an independent contractor for purposes of state taxation. Relationships can be varied too easily. The *activities* conducted by the individual should determine whether an individual is an independent contractor.

If an individual makes sales for more than one principal and holds himself out as an independent contractor in the regular course of his business activities, he is transacting business for himself and not for a particular company. Thus, as long as the individual deals at arm's length with the principal, under the suggested statute he would be treated as an independent contractor. State taxation of his income should relieve the out-of-state company from having its income taxed. However, if the individual transacts business with the principal at less than arm's length, under the definition of part (d)(3) he cannot be an independent contractor. This requirement prevents circumvention of state taxation by out-of-state companies through paying reduced commissions to employees masquerading as independent contractors.

Like all statutes, the suggested statute may provide interpretative difficulties. However, the statute attempts to balance the interests of small businesses against the interests states have in taxing companies that are transacting substantial business within their borders. Although this statute may not be a final answer to the problem, it is a starting point for needed discussion and change of state taxation of interstate commerce under Public Law 86-272.

APPENDIX I

15 U.S.C. § 381 (1982)

§ 381. Imposition of net income tax

(a) Minimum standards

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, 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).

(b) Domestic corporations; persons domiciled in or residents of a State

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to—

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) Sales or solicitation of orders for sales by independent contractors

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

(d) Definitions

For purposes of this section—

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor.