



MULTISTATE INCOME/FRANCHISE TAX

California court declares Franchise Tax Board P.L. 86- 272 guidance invalid Tax Alert

Overview

On December 13, 2023, the San Francisco Superior Court [granted](#) the American Catalog Mailers Association's (the "ACMA") motion for summary judgment, concluding that the California Franchise Tax Board's ("FTB") [Technical Advice Memorandum 2022-01](#) ("TAM 2022-01") and [Publication 1050](#) were void because they constituted regulations that were required to be adopted, but were not adopted, in compliance with the California Administrative Procedure Act ("APA"). TAM 2022-01 and Publication 1050 provided the FTB's interpretation on the manner in which Public Law 86-272 (15 U.S.C. sections 381-384) ("P.L. 86-272") applies to certain activities conducted via the internet.

This Tax Alert summarizes the court's decision and provides some taxpayer considerations.

Background

On February 14, 2022, the FTB issued TAM 2022-01 addressing whether the protections of P.L. 86-272 apply to certain fact patterns now common in business due to technological advancements—namely, whether various activities conducted via the internet constitute in-state activities that exceed the protections afforded by P.L. 86-272. For more information on TAM 2022-01, please see our previous [Tax Alert](#). In May of 2022, the FTB published a revised Publication 1050 (which provides the FTB's guidance on the application of P.L. 86-272 in California) in which the FTB incorporated the guidance it provided in TAM 2022-01.

On August 19, 2022, the ACMA, a non-profit trade association representing direct mail, catalog, online, and other remote-selling merchants and suppliers, filed suit against the FTB, challenging TAM 2022-01 and Publication 1050 and seeking a declaratory judgment on three grounds:

- (1) TAM 2022-01 and Publication 1050 are invalid, because the guidance contradicts the United States ("U.S.") Constitution and P.L. 86-272 (referred herein as "Count I");

- (2) TAM 2022-01 and Publication 1050 are invalid under California Government Code § 11350, because the FTB failed to comply with the APA (referred herein as “Count II”); and
- (3) TAM 2022-01 and Publication 1050 are invalid under California Code of Civil Procedure § 1060, or in the alternative, limiting the application of TAM 2022-01 and Publication 1050 prospectively.

On August 17, 2023, ACMA filed a motion for summary judgment on Count I, which the court denied, concluding that ACMA did not meet its burden of proving that TAM 2022-01 and Publication 1050 were facially invalid. As a part of its August 24, 2023 order, the court also stated that TAM 2022-01 and Publication 1050 were invalid, because they were regulations that were not adopted in compliance with the APA. However, because ACMA had not specifically moved for summary judgment on Count II, the court could not render a decision on that issue.

Summary of the California Superior Court’s order

On September 26, 2023, ACMA filed a motion for summary judgment specifically on Count II – whether TAM 2022-01 and Publication 1050 are invalid underground regulations under the APA. On December 13, 2023, the court granted the ACMA’s motion for summary judgment, holding that TAM 2022-01 and Publication 1050 are void, because they constitute regulations within the meaning of the APA and therefore were required to be adopted, but were not adopted, in compliance with the APA.

The APA requires proposed agency regulations to comply with certain procedural requirements as condition precedent to those regulations becoming effective. Any regulation that substantially fails to comply with these requirements may be judicially declared invalid. Given the FTB had conceded that neither TAM 2022-01 nor Publication 1050 were adopted in compliance with the APA, the primary issue before the court was whether TAM 2022-01 and/or Publication 1050 constitute “regulations” within the meaning of the APA.

The court first noted that a regulation subject to the APA has two principal identifying characteristics:

- First, the agency must intend its rule to apply generally, rather than in a specific case. The rule need not, however, apply universally. A rule applies generally as long as it declares how a certain class of cases will be decided.
- Second, the rule must implement, interpret, or make specific the law enforced or administered by the agency, or govern the agency’s procedure.

The court concluded that both prongs were satisfied. As to the first prong, the court stated that TAM 2022-01 and Publication 1050 were “indisputably . . . generally applicable rules.” The court reasoned that both documents articulate general rules that declare how a certain class of cases will be decided. For example, TAM 2022-01 provides twelve fact patterns that apply to a class of businesses that make sales to California customers, are commercially domiciled outside of California, and have no other activities in California other than those mentioned in the fact patterns. Additionally, Publication 1050 was intended to serve as general guidance to taxpayers and provides a general rule that when a business interacts with a customer via the business’s website or app, the business engages in a business activity within the customer’s state.

With respect to the second prong, the court stated that the FTB did not dispute that TAM 2022-01 and Publication 1050 interpret the FTB’s application of P.L. 86-272 to out-of-state businesses. Notably, TAM 2022-01 was solely focused on interpreting P.L. 86-272 in the context of internet sales, and Publication

1050 states that its purpose was to provide notice as to how California will apply the statute.

Although the FTB raised various arguments in opposition to ACMA's motion for summary judgment, the court was not persuaded by those arguments and concluded that each of TAM 2022-01 and Publication 1050 constituted a regulation within the meaning of the APA and was not adopted in compliance with the APA. Accordingly, both TAM 2022-01 and Publication 1050 are invalid regulations.

Considerations

On December 18, 2023, the court entered judgment in favor of ACMA. The FTB generally has 60 days to file an appeal to the California Court of Appeal. If the FTB appeals, the court's judgment will not be final pending the outcome of the FTB's appeal to the California Court of Appeal. If the FTB does not appeal, the court's judgment generally will become final after the time for appeal has expired (e.g., 60 days).

Whether a taxpayer is protected under P.L. 86-272 is a fact-intensive inquiry. Taxpayers should consult their tax practitioners to discuss the impact the court's decision may have on their California income tax filing and payment obligations.

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