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TAX LAW

To Tax or Not To Tax?

If a company's only activity in a state is related to the solicitation of sales orders, the state may not impose income tax on that company

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Many companies sell their products through salespeople who live and work in states where the company does not have an office or other physical presence. A company's presence in a state, through its resident salesperson, may prompt the company to seek the state's authority to do business there as a foreign company. The state will usually assume that if a company is authorized to do business there, the state also has jurisdiction to assess income tax on the income the company earns there; but this is not necessarily the case.

At a time when states are seeking more revenue and resorting to more creative taxing schemes, multistate companies have become targets of very aggressive behavior by state revenue departments, resulting in an increased requirement that such companies pay income taxes in their jurisdiction. It may be worthwhile for a company to examine whether it is truly required to pay income tax on income derived within a state's border, particularly if its activities in the state fall within the category of solicitation of orders for sales of tangible personal property, and such orders are sent outside the state for acceptance or rejection.

Whether a company must pay income tax is a complex question, involving constitutional law, federal statute, state tax rulings and other factors. The Due Process and Commerce Clauses of the United States Constitution limit a state's right to tax an out-of-state company to situations in which the company's activities within the state create a sufficient nexus to the state to justify the taxation. U.S. Const. art. I, § 8, cl. 3 (Commerce Clause); U. S. Const. amend. XIV, § 1 (Due Process Clause). Without such a connection, a state's taxing scheme will be struck down as unconstitutional. The presence of a salesperson in a state may provide adequate nexus, but the activities of the salesperson should be closely examined to determine if such activities have Constitutional protection.

Guidance from the U.S. Supreme Court on the application of this principle was in flux throughout most of the twentieth century. Then the Court issued a landmark decision on this issue in the combined cases of *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959). That decision permitted states to impose income tax on foreign companies that were engaged exclusively in interstate commerce and maintained sales offices in the taxing state in order to sell goods that were manufactured outside the state.

Following outcries from the business community resulting from this decision, Congress responded by enacting the Interstate Income Tax Act of 1959, later revised to become the Interstate Income Tax Act, 15 U.S.C. §381 (Public Law (P.L.) 86-272). This law sought to establish a statutory minimum standard for state income taxation in the case of sales of tangible personal property by a company's representatives within a state. The act expressly prohibits a state from imposing an income tax on a company when the only business activities of the company within the state consist of the solicitation of orders by the company or its representative, for the company or in the name of or for the benefit of a prospective customer, for tangible personal property, as long as the 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.

Public Law 86-272, however, did not define the term "solicitation." This

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lack of a definition led to state court decisions that attempted to interpret the law both narrowly and broadly. The Supreme Court finally provided some guidance as to the meaning of "solicitation" in P.L. 86-272 in *Wisconsin Dep't of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214 (1992). In *Wrigley*, the Court considered whether activities of the defendant company were protected from income taxation by Wisconsin. The Court concluded that if the only activities of a company in a state are ancillary to the solicitation of orders (that is, serve no business function for the company other than their connection to the solicitation of sales), the state may not impose income tax on the state-derived income of that company. However, the Court went on to hold that if more than a de minimis amount of the company's activities in the state, even if undertaken by salespersons, are not ancillary to the solicitation of orders but are actions that the company would take regardless of which employee performed them, the state may impose its income tax on the company. In determining whether unprotected activities were de minimis, the Court examined whether such activities established "a nontrivial additional connection with the taxing State."

The Court found that certain activities of Wrigley's salespersons in Wisconsin were not ancillary to the solicitation of sales. Specifically, the replacement of stale gum, the supplying of gum for display (while charging the shopkeeper for the gum supplied) and the storage of gum, including the rental of storage space in-state for that purpose, were not sufficiently related to the solicitation of sales.

The Court explained that "solicitation" includes "those activities that are entirely ancillary to requests for purchases — those that serve no independent business function apart from... soliciting orders." On the other hand, the Court ruled that Wrigley's in-state recruitment, training and evaluation of its sales people and the involvement of Wrigley's regional sales manager in credit disputes with customers were activities that were ancillary to the solicitation of sales. But the Court determined that the amount and nature of the company's unprotected activities within the state, taken together, were not de minimis and therefore gave rise to an obligation of Wrigley to pay income tax to Wisconsin.

Activities that have been found to be ancillary to the solicitation of orders in other cases include displaying samples, discussing prices and discussing specifics of the customer's order (*Pomco Graphics, Inc. v. Dir., Div. of Taxation,* 13 N.J. 578 (1993)) and leaving software demonstration disks with potential customers (*AccuZIP, Inc. v. Dir., Div. of Taxation,* 25 N.J. Tax 158, 182 (N.J. Tax Aug. 13, 2009). Another court found such activities as handling customer service complaints, working with customers to plan for future inventory needs and helping customers measure brand loyalty to be more than ancillary to the solicitation of sales and warranted taxation. *Estee Lauder Services, Inc. v. Dep't of Revenue,* 16 Or. Tax 279 (Or. Tax Magistrate Div. Oct. 30, 2000). Also, testing the performance of the company's products, reporting on the tests, doing inventory reports, and making frequent in-plant presentations to large numbers of employees of the customer, were found not to be sufficiently related to sales and therefore constituted a basis for imposition of state income tax. *Kennametal, Inc. v. Comm'r of Revenue,* 426 Mass. 39 (1997).

In 1994, the Multistate Tax Commission (MTC), an organization in Washington, D.C., dedicated to promoting uniformity in multistate taxation, issued a revision to its "Statement of Information Concerning Practices of the [MTC] States Under Public Law 86-272." This statement, with which states that are members of the MTC have agreed to comply, provides guidance as to which activities should not give rise to income taxation and which are likely to lead to taxation. See "Statement of Information Concerning Practices of the Multistate Tax Commission States Under Public Law 86-272," March 21, 1994; Third Revision adopted July 27, 2001.

If a company's only presence in a state is its sales representatives but the state is imposing income tax on the company, the company might consider whether P.L. 86-272 would apply and relieve the company of income tax liability to that state. ■