

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
[Redacted]) DOCKET NO. 18901 and 18902
)
) DECISION
Petitioners.)

On April 19, 2005, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (“Petitioners”) asserting a total Idaho income tax liability in the amount of \$156,046 for the taxable years ending September 29, 2001; September 28, 2002; and September 27, 2003. The Audit Division issued a second Notice of Deficiency Determination on April 19, 2005 to [Redacted], (“Petitioners”) asserting a total Idaho income tax liability in the amount of \$36,724 for the taxable year ending September 29, 2001. On December 7, 2005, the Petitioners filed a petition for redetermination and requested that a decision be issued based on the information in the file. The Tax Commission, having reviewed the file, upholds the April 19, 2005, Notices of Deficiency Determination.

PROCEDURAL HISTORY

A field audit was conducted at [Redacted]’s tax department offices in [Redacted] during the week of October 4, 2004. [Redacted] and [Redacted] and their subsidiaries filed combined Idaho corporate income tax returns on a water’s edge basis. The current protest involves taxable years 2001 through 2003. The Tax Commission’s audit staff made a number of audit adjustments to the returns filed by [Redacted] and [Redacted] and their subsidiaries and combined the returns on a worldwide basis.

ISSUES PROTESTED

According to the protest letter submitted by the Petitioners dated June 17, 2005, the Petitioners have raised the following issues:

1. Whether [Redacted] engaged in activities within Idaho that exceeded the protection of Public Law 86-272 for the tax year September 29, 2001, and if so, whether those activities were de minimis.

2. Whether a water's edge election must be made on the prescribed form or whether documentation clearly indicating an intent to make a water's edge election is acceptable.

FACTS

[Redacted] is the world's largest processor and marketer of [Redacted], and the [Redacted]. [Redacted] produces a wide variety of brand name [Redacted] products marketed in the United States and more than 80 countries around the world. [Redacted] is the recognized market leader in the [Redacted] markets it serves. The company has [Redacted].

On September 28, 2001, [Redacted] acquired [Redacted]. [Redacted] is the world's largest manufacturer of [Redacted]. As a result of the [Redacted] acquisition, [Redacted] became the world's largest [Redacted] provider.

The Company's products are marketed and sold to national and regional [Redacted]. Sales are made by the company's sales staff located in [Redacted] in regions throughout the United States and in several foreign countries.

During the 2001 tax year, [Redacted] employed a sales representative in Idaho. The auditors sent a nexus questionnaire to the former employee and followed up with a personal interview. Based on the answers to the questions posed by the Tax Commission, the auditors determined that the Petitioners' contacts with Idaho exceeded the protection of Public Law 86-272.

The Petitioners filed their Idaho corporate income tax returns on a water's edge basis. Although the Petitioners did not file a water's edge election Form 14, they argue that the Tax

Commission should accept the water's edge filing method because their tax computation schedule attached to the Idaho income tax return clearly shows that they were computing the tax under the water's edge method.

ANALYSIS

Nexus

The United States Constitution imposes certain restrictions on a state's power to subject out-of-state corporations to taxes on their business activities in interstate commerce. Under the Due Process Clause, a minimum connection must exist between a state and the person, property, or transaction the state seeks to tax. *Quill Corp. v. North Dakota*, 504 U.S. 298, 305, 112 S.Ct. 1904, 1909 (1992). The Commerce Clause also limits a state's taxing jurisdiction to activities with a substantial nexus to the taxing state. *Id.* at 311, 112 S.Ct. at 1912. For an entity conducting business in Idaho with sufficient contacts to satisfy the requirements of the Due Process Clause and the Commerce Clause, Idaho may assert its taxing authority unless the entity comes within the protection of Public Law 86-272.

Public Law 86-272 was enacted by Congress in 1959 as an express limitation on the ability of the several states to impose an income or franchise tax. The Public Law provides that a nondomiciliary corporation is not subject to the income tax jurisdiction of a foreign state if that corporation's "only business activity within the State consists of 'solicitation of orders' for tangible goods, provided that the orders are sent outside the State for approval and the goods are delivered from outside the state." *Wisconsin Dep't of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214, 216, 112 S.Ct. 2447, 2450 (1992). Because Public Law 86-272 is an express federal preemption on the ability of the several states to impose an income tax on certain businesses, the provisions of the Public Law are narrowly construed. *C.f. Dep't of Revenue of Oregon v. ACF*

Industries, Inc., 510 U.S. 332, 345, 114 S.Ct. 843, 851 (1994) (“We will interpret a statute to pre-empt the traditional state powers only if that result is the ‘clear and manifest purpose of Congress’.”). To the extent a company engages in activity outside the protection of 86-272, if the activities, taken as a whole, are *de minimis*, that company is exempt from the income tax laws of the taxing state.

Under 86-272, the term “solicitation of orders” covers three types of activities: (1) express solicitation of orders for tangible goods, (2) implied solicitation of orders for tangible goods, and (3) any activity that is “entirely ancillary” to express or implied solicitation of orders for tangible goods. *Wrigley* at 223, 228 - 229, 112 S.Ct. at 2453 - 2454, 2456. An activity is entirely ancillary to express or implied solicitation if it serves no legitimate business purpose outside the solicitation of orders for tangible goods. *Id.* For example, “[p]roviding a car and a stock of free samples to salesmen is part of the ‘solicitation of orders,’ because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company’s products is not part of the ‘solicitation of orders,’ since there is good reason to get that done whether or not the company has a sales force.” *Id.* at 229, 112 S.Ct. at 2457.

The Audit Staff determined that [Redacted]. engaged in business activity within Idaho that exceeds the protection afforded by Public Law 86-272. [Redacted]. argues that [Redacted] did not have nexus with Idaho for the tax year ending September 29, 2001. For all other years under audit, [Redacted] agrees that they engaged in activities outside the protection of Public Law 86-272. The Tax Commission finds the evidence set forth in the audit file is sufficient to support a determination that [Redacted] engaged in activities outside the protection of Public Law 86-272.

The Audit Staff based their determination on responses to a nexus questionnaire and on an interview of the [Redacted] Sales representative within Idaho. The [Redacted] Sales representative was the regional sales manager for all [Redacted] products within a western region including Idaho. The employee moved to Idaho in late 1999 or early 2000 and left the company at the end of 2001 on good terms.

In addition to the solicitation of orders and ancillary activities protected by Public Law 86-272, there were several activities performed by the [Redacted] Sales representative which fall outside the scope of protection afforded by Public Law 86-272. These activities included testing, analyzing and reviewing product performance, investigating complaints of customers, making decisions regarding defective products, making adjustments for returned or damaged merchandise, solving problems such as shipping, product shortages, and warehouse performance, and training customers, wholesalers, and independent brokers in the use of [Redacted] products. It appears that, taken as a whole, these activities are sufficient to create a taxable nexus with Idaho.

Specifically, the [Redacted] Sales representative was responsible for investigating customer problems within his territory and determining how to handle the issue by sending new product, returning the product, etc. While this activity may facilitate more sales, it could be handled by quality assurance personnel and, therefore, is not entirely ancillary to the solicitation of orders.

In addition to training wholesalers and independent brokers on the use of [Redacted] products, the [Redacted] Sales representative also trained other people outside of those involved in solicitation of orders. The employee would work with [Redacted] on the proper [Redacted] in order to enhance the quality. For example, he taught [Redacted] on the

proper [Redacted]. Training those people who ultimately use the product exceeds the act of requesting an order for the product.

It appears that the majority of [Redacted] product shipments to Idaho were by [Redacted]'s own shipping company. According to the [Redacted] Sales representative, after the [Redacted] product was delivered in Idaho, the carrier would often haul [Redacted] back to [Redacted] for another company. In addition, when a [Redacted] product was recalled, it was usually backhauled by [Redacted]'s carrier. These activities would not be considered a solicitation of orders or ancillary thereto, and thus the [Redacted]shipping activities would not be protected by Public Law 86-272.

The activities of the [Redacted] Sales representative and the [Redacted]shipping company, taken as a whole, appear to exceed a de minimis level. As such, the activities create a sufficient taxable nexus with Idaho.

Water's-Edge Election

Idaho applies combined reporting to commonly controlled, unitary groups of corporations. The default method is worldwide combination, in which the income and factors of all commonly owned members of the unitary business are combined and apportioned. I.C. § 63-3027(t).

Idaho Code § 63-3027B affords a “qualified taxpayer” the privilege of electing the “water’s-edge” filing method. Under this method, the combined income and factors include only unitary corporations that either file a federal tax return or are included in a federal consolidated return and exclude corporations filing elections under § 936 of the Internal Revenue Code. A “qualified taxpayer” is a corporation which files, with its Idaho return on which the water’s-edge

election is made, a consent to the reasonable production of documents within Idaho. I.C. § 63-3027B(b)(3).

Under Idaho Code § 63-3027C(a), a water's-edge election must be made with the original return and all future returns are bound by the election. [Redacted]. has been filing worldwide combined returns with the state of Idaho for several years. [Redacted] acquired [Redacted]. during the taxable year ending September 29, 2001. [Redacted] did not file Idaho income tax returns prior to acquiring [Redacted].

In the taxable year ending September 28, 2002, [Redacted] filed water's-edge combined Idaho returns. [Redacted] did not include the water's-edge election Form 14 with its tax return. The audit staff recomputed [Redacted]'s unitary income on the worldwide combined reporting method for all audit years.

[Redacted] acknowledged that they did not file a proper water's-edge election. However, they believe that Idaho should accept the water's-edge method because their tax computation schedule attached to the Idaho return clearly shows that they were computing tax under the water's-edge method.

The water's edge election is a privilege granted by a very detailed and specific statute, the terms of which must be strictly followed. Because the Petitioners failed to file Form 14, the Petitioners' water's-edge filing method cannot be recognized and the water's-edge election is now barred.

CONCLUSION

WHEREFORE, the Notices of Deficiency Determination dated April 19, 2005, are hereby MODIFIED in accordance with the foregoing analysis, and as so modified are hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the Petitioners pay the following tax, penalty, and interest:

[Redacted]

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL AMOUNT DUE</u>
2001	\$ 7,016	\$ - 0 -	\$ 1,944	\$ 8,960
2002	54,391	- 0 -	11,307	65,698
2003	79,009	- 0 -	12,443	91,452

[Redacted]

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL AMOUNT DUE</u>
2001	\$ 30,467	\$ - 0 -	\$ 8,441	\$ 38,908

Interest is calculated through August 31, 2006.

DEMAND for immediate payment of the combined total amount of \$205,018 is hereby made and given.

An explanation of the Petitioners' right to appeal this decision is enclosed with this decision. As set forth in the enclosed explanation, you must deposit with the Tax Commission 20 percent of the total amount due in order to appeal this decision. The 20 percent deposit is held as security for the payment of taxes until the appeal is finally resolved.

DATED this _____ day of _____, 2006.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2006, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]

Receipt No.
