OREGON

Oregon Court: No P.L. 86-272 Protection For Tobacco Manufacturer

by Andrea Muse

A tobacco manufacturer is subject to Oregon's corporation excise tax because of activities relating to its returned goods policy and pre-book orders made by its representatives, according to the state tax court.

The Oregon Tax Court, Regular Division, ruled August 23 in *Santa Fe Natural Tobacco Co. v. Department of Revenue* that the out-of-state tobacco manufacturer is subject to the tax, finding that the company lost its immunity to the net income tax because its policy requiring wholesale customers to accept all returned goods and the pre-book orders made by its representatives exceed P.L. 86-272 protection.

Larry Brant of Foster Garvey PC told *Tax Notes* August 26 that this case "exemplifies a possible erosion to the protections afforded by P.L. 86-272" and "reflects the close scrutiny states are taking with respect to P.L. 86-272 and out-of-state taxpayer activity." He said both sides made cogent arguments, but the decision illustrates that P.L. 86-272's protection is not absolute and that taxpayers should revisit their activities in other states and determine whether they're protected.

Brant said that in his mind, the case is an extension of the Oregon Tax Court's 2011 decision in *Ann Sacks Tile & Stone v. Department of Revenue*, which held that plumbers with whom Kohler Inc. had contracted to meet its warranty obligations were performing the work on behalf of the company and that the activity was beyond the protection of P.L. 86-272. He noted that the taxpayer in this case required its wholesale customers to accept all returns, which the court concluded was an activity conducted on behalf of the taxpayer that went beyond the protection of P.L. 86-272.

Michelle DeLappe of Fox Rothschild LLP told *Tax Notes* that the "decision emphasizes the traps and pitfalls for taxpayers who believe their activities are within those protected by P.L. 86-272." She said out-of-state taxpayers should avoid delegating to in-state persons any duty to accept and process returns of rejected

merchandise and noted that the out-of-state taxpayer here, apparently, should not have its in-state sale representatives forward written confirmation of orders to the retailers to convert a phone order into an actual confirmed order. She said the latter seemed to be the weakest part of the decision, adding, "It is hard to see how confirming orders is independent from soliciting orders."

Noting that the decision can be appealed directly to the state supreme court, DeLappe said that even if further proceedings occur, the decision is a "cautionary example of how narrow P.L. 86-272 protections can be."

Opinion

Santa Fe Natural Tobacco Co. manufactures, markets, and distributes cigarettes and tobacco products that it sells to wholesalers located in Oregon but does not have any offices or inventory of its own for sale or return in the state.

The company filed Oregon corporation excise tax returns for the 2010 through 2013 tax years and paid the annual $150 minimum tax. It reported no Oregon taxable income on the basis that P.L. 86-272 immunized its income from Oregon's tax, attaching a statement to the returns that its activities in the state were limited to the solicitation of sales.

The Oregon Department of Revenue audited the returns and concluded that P.L. 86-272 did not protect the company. It assessed tax, interest, and penalties for substantial underpayment of tax and failure to pay the tax.

The magistrate division of the tax court agreed with the DOR that Santa Fe was not immune from taxation under P.L. 86-272, and the company appealed.

Noting that the DOR identified activities relating to Santa Fe's returned goods policy as well as its representatives making pre-book orders as bases for the position that P.L. 86-272 did not provide the company immunity from the state's corporation excise tax, the regular division of the tax court stated that if it were to agree with the DOR on either issue, the company would be subject to the tax.

According to the court, Santa Fe has a 100 percent product guarantee for its brand products and a wholesale returned goods policy that was part of the terms and conditions of sale of its products to wholesalers. The policy requires wholesalers to accept and process returns of products from Oregon retailers under the agreements, though Santa Fe had no right to control the wholesalers' personnel decisions or the way they carried out the tasks.

Santa Fe argued that accepting returns was a best practice that benefited both the manufacturer and the wholesaler, which would not support the inference that the returns were accepted on Santa Fe's behalf. But the court rejected that argument, concluding that the activity did not have to solely benefit the out-of-state seller for the activity to be done on behalf of the seller.

Noting that nothing in the record showed that wholesalers of other cigarette brands or wholesalers in general followed a practice of accepting all returns of goods, the court determined that requiring the wholesaler to accept all returns served Santa Fe's interest and established that the activity was on behalf of the company.

The court added that the relationship of acting on behalf of Santa Fe was different from the relationship of agency, finding that the company's lack of control over the wholesalers did not mean the wholesalers weren't acting on its behalf.

The court looked to the U.S. Supreme Court's decision in *Wisconsin Department of Revenue v. William Wrigley Jr. Co.* to determine whether the activities were ancillary to making sales, observing that most of the in-state activities "treated as ancillary to solicitation helped to prepare the employee representatives for solicitation." But replacing stale gum free of charge and making small on-the-spot sales were not considered ancillary to solicitation, the court said.

Finding that the acceptance of returns exceeded the bounds of "making sales" for purposes of P.L. 86-272, the court concluded that the policy of requiring wholesalers to accept all returns for any reason "is not a behind-the-scenes, preparatory activity like providing basic tools (a car, or free samples) and training."

Pre-Book Orders

Santa Fe's sales representatives did not carry inventory for sale but would sometimes take

orders authorized by an Oregon retailer and forward them to an Oregon wholesaler. The court rejected the DOR's contention that this activity amounted to making sales, concluding that it was ambiguous whether the wholesaler was obligated to fulfill a pre-book order.

But the court ruled that placing pre-book orders was not entirely ancillary to the solicitation of orders and exceeded the protection of P.L. 86-272, finding that the activity addressed retailers' failure to follow through with orders — which "was something Taxpayer had reason to do apart from soliciting orders."

Finding that the acceptance of returns was regular and systematic, and that the taxpayer had not shown that the number of pre-book orders was trivial, the court concluded that the activities exceeded a de minimis level.

But the court also found that Santa Fe was not subject to the substantial underpayment penalty, stating that the DOR did not dispute that the company had adequately disclosed its reliance on P.L. 86-272 for immunity from the tax and that the company's positions, though incorrect, were reasonably based on P.L. 86-272 or *Wrigley*.

The court added that the lack of case law supporting the taxpayer's position was "neither surprising nor fatal to Taxpayer's argument," given that the U.S. Treasury Department does not administer P.L. 86-272 and it is up to each state that has an income tax to enforce the statute.

The taxpayer in *Santa Fe Natural Tobacco Co. v. Department of Revenue* (TC 5372) is represented by Carol Lavine of Carol Vogt Lavine LLC and Mitchell Newmark of Blank Rome LLP. ■