The California Office of Tax Appeals Issues a Precedential Opinion on Public Law 86-272 Concerning Out-of-State Businesses that Solicit Sales in California

by Robert S. Horwitz

In a 1959 opinion, the U.S. Supreme Court held that an out-of-state business whose sole contact with a state was to have "drummers" go into the state to solicit orders could be taxed by that state on income from those sales. In response, Congress enacted Pub. Law 86-272 to limit the power of states to impose a net income tax on out-of-state sellers who have limited business activities within the state. To fall within P.L. 86-272's protection, an out-of-state seller's in-state business activity must generally be limited to the "solicitation of orders" for the sale of tangible goods, provided that the orders are sent to a location outside the taxing state for approval and the orders are filled by shipment or delivery from a location outside the taxing state. Pub. Law 86-272 is codified at 15 U.S.C. §§ 381-384.

> Section 381 provides in pertinent part:
>
> (a)Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a 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:
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> (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
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> (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) 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), 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, or tangible personal property.

The U.S. Supreme Court addressed Pub. Law 86-272 in *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992), where it stated that P.L. 86-272's "minimum standards" for when a state can impose a tax on net income derived from interstate commerce are "somewhat less than entirely clear." Wrigley is a Chicago based gum manufacturer with no operations or real property in Wisconsin. Its sales representatives carried fresh packages of gum and, if they discovered that gum at a retailer was stale, would remove the stale gum and replace it with fresh gum at no charge to the retailer. The *Wrigley* Court held that an out-of-state seller would not "forfeit" the tax immunity conferred by P.L. 86-272 if the seller's only in-state activities consisted of the solicitation of orders, activities "entirely ancillary" to solicitation, and de minimis activities.

It found that the activities of the sales representatives in removing stale gum and replacing it with fresh gum was more than de minimis and was not "entirely ancillary" to the solicitation of orders and thus was not protected by P. L. 86-272. As a result, Wisconsin could impose income tax on the net income of Wrigley from sales within the state.

Facts in *Appeal of Ken's Foods, Inc*.

In *Appeal of Ken's Foods, Inc*., 2026-OTA-249P, the California Office of Tax Appeals addressed the application of Pub. Law 86-272 to sales in California by an out-of-state company. Ken's Foods (Ken's) is a Massachusetts corporation that manufactures and sells dressings and marinades. It has no facilities, warehouses or inventory in California, does not own or lease real or personal property in California, but leased several autos that were used by its California employees. Ken's was headquartered in Massachusetts. It had a test kitchen in Massachusetts for research and development purposes ("R&D").

Ken's did not pay income tax to California on its sales in state, relying on Pub. Law 86-272. The Franchise Tax Board ("FTB") determined that Ken's activities in California were neither de minimis nor entirely ancillary to the solicitation of order and, thus, were not protected by the statute. It therefore proposed assessments against Ken's for 2012 and 2013.

Ken's had two Retail Managers, two Food Service Managers, and a Corporate Chef in California in 2012 and 2013. Retail Managers solicited orders from food retailers in California, with the orders placed electronically with Ken's headquarters in Massachusetts. Food Service Managers solicited orders from restaurants in California, which would order products from distributors. The distributors electronically placed the orders with Ken's headquarters. All orders were shipped to California customers via third-party carriers.

Ken's had a contract with Acosta, a Florida-based sales and marketing agency with offices in California, to act as its non-exclusive third-party broker for the retail business. Acosta was paid on a commission basis. It maintained a direct relationship with Ken's retail customers.

Retail Managers worked from home. Their focus was on increasing sales and building relationships with retailers. The Retail Managers met quarterly with major customers and regularly visited supermarkets for "store checks" to identify customer needs and shortcomings with Ken's products. Retail Managers did not take orders from retailers or replace stock. If a retailer had an issue, it was addressed through Acosta. Retail Managers also conducted store audits as part of supermarket visits to verify distribution, promotions, shelving, and displays.

Acosta used "planograms" to increase sales; a planogram instructed retailers on how to properly shelve and display Ken's products in the retailer's stores, including product placement. Once a retailer approved the planogram, Acosta implemented it at the retailer store level.

Food Service Managers worked from their homes and had various duties. Their primary duties included:

- Developing and maintaining strong personal relationships with National Account customers.[1]
- Developing relationships with National Account culinary/R&D groups and becoming involved in projects during the ideation stage to assure opportunities for new products in order to solicit sales of new products.
- Working closely with Ken's R&D and Chefs on National Account Proprietary Products.
- Presenting menu ideations to top accounts to solicit sales and gain incremental volume.
- Working with Ken's internal support team (R&D, supply chain management, purchasing, field sales, chefs, etc.)

Food Service Managers (a) called on food service establishments; (b) presented and solicited sales for new items; (c) identified new food service customers; and (d) presented Ken's "capabilities" to new food service

[1] "National Account" is a group within Ken's that handles customers that are nationwide restaurant chains.

customers. They would also work with chain restaurant customers to identify competitor's products that could be replaced by Ken's and worked with the customer and Ken's R&D to develop the replacement product. At the request of a chain restaurant customer, Food Service Managers would pick up competitors' products and send them to Ken's headquarters to select Ken's products that could replace the competitor's ("product matching"). If an existing product could not be matched, Ken's R&D would develop a new product for the customer ("product creation") based on the customer's flavor profile.

The Corporate Chef served California and other states. The Corporate Chef was involved in "menu ideation," which was creating menus that used Ken's products; developed relationships with Chefs and Culinary support teams at restaurant chains to solicit additional dressing and sauce opportunities; made presentations with Food Service Managers, during which the Corporate Chef cooked dishes using Ken's products. The Corporate Chef also worked with Ken's salespeople in showing food service customers how to use Ken's products and instructed salespeople on the uses of seasonal sauces so they could instruct food service customers on the uses of those sauces to solicit sales.

The FTB audited Ken's and determined that its sales in California were not protected from California income tax because the following six activities were unprotected: (1) stock checks, retail audits and display compliance; (2) Acosta's use, discussion, and implementation of planograms; (3) Acosta's alleged stock replacement, quality control, and handling of customer complaints; (4) collecting competitor samples and customer information for product matching and product creation; (5) the Food Service Managers' business reviews; and (6) the Corporate Chef's menu ideation. After failing to resolve the dispute with the FTB's protest unit, Ken's appealed to the OTA.

OTA's Analysis of the Six Activities

Initially, the OTA discussed Pub. Law 86-272 and the *Wrigley* case. It then turned to each of the six activities the FTB claimed were unprotected to determine whether Ken's activities in California exceeded the protection afforded by Pub. Law 86-272.

A. Stock Checks, Retail Audits and Display Compliance

Unlike Wrigley, Ken's Retail Managers did not provide retailers with product or charge retailers for supplying products during retail audits or checking display compliance. This was done to ensure that retailers properly displayed Ken's products and advertised a deal on products to increase retailer sales to end customers and thus get more orders from retailers.

The OTA rejected the FTB's claim that stock checks, retail audits and display compliance served a business purpose other than soliciting sales. Noting that in cases involving Pub. Law 86-272, that it was appropriate to consider decisions of other courts, it discussed the Minnesota Tax Court's opinion in *Skagen Designs, Ltd. v. Commissioner of Revenue*. Skagen involved a Nevada company that distributed wristwatches and jewelry to retail stores. Skagen's sales representatives visited retail customers and inspected, rearranged and refilled display cases and towers with Skagen's watches based on a planogram. The Minnesota Tax Court held that these activities were entirely ancillary to the solicitation of sales.

The OTA also looked to *Blue Buffalo Company, Ltd. v. Comptroller of Treasury*, 243 Md.App. 693, (Md. Ct. Spec. App. 2019), which involved a company that formulated and sold premium pet food through national chains and independent retailers. Its employees would periodically rework product displays and check retailer inventories to ensure Blue Buffalo's products were in inventory. The Maryland court found these activities were protected. Finding that the Retail Managers' stock checks, audits and display compliance activities were analogous to those of Skagen's sales representatives and Blue

Buffalo's employees, the OTA determined these activities to be merely ancillary to solicitation.

B. Planograms

The planograms are advice to retailers on how to display goods to the public. The OTA again looked to the *Skagen* case and noted that there was no evidence that Skagen's employees were more involved in the development and use of planograms then was Acosta. The FTB failed to show that "Acosta's planogram use, discussion and implementation was an unprotected activity."

C. Alleged Stock Replacement, Quality Control and Customer Complaints

The FTB claimed that interviews of the Retail Managers and the Food Service Managers showed that Acosta performed stock replacement. In *Wrigley*, the Supreme Court held that the replacement of stale gum was not a protected activity.

According to the OTA, the cited language from the interviews referred to restocking, not stock replacement. Restocking is unprotected if it serves an independent business purpose. The OTA observed that restocking could be asking the retailer to refill inventory or the out-of-state seller's employees pulling bad product from retailer shelves and restocking.

Evidence in the record contradicted the FTB's claim that Acosta replaced stock. Acosta did not charge retailers to restock inventory. It did not restock stale or defective inventory. The evidence was that Acosta restocked retailer shelves for reorder purposes, which was not an independent business purpose.

The FTB also asserted that Acosta resolved customer issues and complaints, but the evidence indicated that Acosta only forwarded complaints to Retail Managers. A number of cases have held that reporting customer complaints was protected activity because it is "ancillary to solicitation by virtue of its role in ingratiating the customer and facilitating requests for purchases." Since the

evidence was that Acosta acted as an intermediary between the retailer and Ken's Foods, its handling of customer complaints was protected activity.

D. Product Matching and Product Creation

To determine whether product matching and product creation were protected activities, the OTA looked to *Kennametal, Inc. v. Commissioner of Revenue* (1997) 426 Mass. 39. The taxpayer developed, manufactured and sold cutting bits and related products. Its sales employees used samples for testing its products and to prepare reports based on the test results. The court found that these activities were designed not only to solicit orders, but to ingratiate customers and assist buyers in knowing what to order and that these were reasons independent of soliciting orders so that the taxpayer was not protected by Pub. Law 86-272.

Ken's Food Service Managers collected samples to maintain customer relationships with recurring food establishment customers in response to product matching requests and to identify Ken's products that were comparable to competitor products. This served the same purposes as in *Kennametal*. And while Ken's R&D team performed the work of matching product and product creation, the Food Service Managers worked closely with the R&D team to produce product samples acceptable to food establishment customers. The Food Service Managers' "collection of samples for testing by the R&D team in Massachusetts supports a finding that appellant had reasons independent of soliciting orders, beyond merely facilitating a customer inquiry or verifying a product that could be ordered, for engaging in product matching and product creation."

Food establishment customers requested product matching because they didn't know which of Ken's products was a comparable replacement product and the R&D team created a product because it could not identify Ken's existing product that matched the customer's needs. "While product matching and product creation undoubtedly helped to increase sales, there was good reason to acquire competitor samples and customer-provided information, whether or

not appellant employed a California sales team. Thus, product matching was not ancillary to solicitation.

E. Business Reviews

The OTA rejected the FTB's argument that business review were not protected activities. The Food Service Managers job included developing customer relationships, in furtherance of which they met with food establishment customers and conducted business reviews to better address specific needs of certain customers and maintain customer loyalty and retention. The OTA termed this a "classic solicitation technique" since it was designed to enable third-party distributors to place more orders of Ken's products to fill food establishment customer orders.

F. Menu Ideation

The Corporate Chef's primary job included "conducting menu ideations" to find different uses for Ken's products so more could be sold. The OTA found that some aspects of menu ideation, such as the Corporate Chef's preparation and presentation food samples to food establishment customers were clearly solicitations goals meant to entice the customer to buy more of Ken's products.

Other aspects, however, served an independent business purpose beyond soliciting sales of Ken's products. These included finding different uses for Ken's products, market research on customers, the Corporate Chef's discussions with chefs and culinary staff of restaurants to help him select Ken's products that would pair well with the flavor profile of the customer's restaurant. Since these activities in California had an independent business purpose beyond soliciting sales, the OTA held that it was unprotected activity.

G. Whether, Taken Together, Unprotected Activities Performed on Ken's Behalf Were *de minimis*

Under *Wrigley*, unprotected activities are not de minimis when, taken together, the activities constitute nontrivial additional connections with the state. The OTA held that Ken's had not shown that the unprotected activities of collecting

competitor samples for product matching and product creation and the Corporate Chef's menu ideation were de minimis. These activities were part of the primary functions of the Food Service Managers and the Corporate Chef and thus part of regular company policy and were performed by Ken's employees in California. These activities were conducted on a continuing basis and established nontrivial connections to California.

The OTA concluded that Ken's California activities exceeded the protection of Pub. Law 86-272 and thus, the FTB's proposed assessment was sustained.

Conclusion

Pub. Law 86-272 was enacted over 65 years ago. The statute has not been amended since enactment despite major changes in how commerce is conducted. Because the statute does not define "solicitation of orders," an out-of-state business that sells products in California must be careful in what its employees do within the state on its behalf. As shown by *Appeal of Ken's Food, Inc.*, activities of employees and independent contractors that are meant to sell more product can be viewed by an adjudicatory body as having a business purpose besides soliciting sales.

Tax advisors to an out-of-state business selling tangible personal property in California must review the activities of the business' employees to ensure that the business does not step over the line and engage in activities that may have an independent business purpose beyond just soliciting sales. And in conducting such a review, the tax advisor must be prepared to defend the business' activities in an audit and before the OTA or a state court.

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