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1 of 18 DOCUMENTS

NAME: IN RE: * * *

NUMBER: HEARING NO. 40,927

COURT: COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS

CITE: 2002 *Tex. Tax LEXIS 204*

DATE: October 21, 2002

PANEL: [*1]

ANNE K. PEREZ, Administrative Law Judge

COUNSEL: ELIAS V. LORENZANA, JR., Representing Administrative Hearings Section

* * *, Representing Petitioner

OPINIONBY: PEREZ

TAXPAYER NO.: * * *

AUDIT OFFICE: * * *.

AUDIT PERIOD: 1997 THROUGH 1998

FRANCHISE TAX/RDT

COMPTROLLER'S DECISION

PRELIMINARY DISCUSSION:

An oral hearing was held on June 5, 2002. * * *, Petitioner's representative, presented the testimony of * * *, Petitioner's * * *. Assistant General Counsel Elias V. Lorenzano, Jr. represented the Administrative Hearings Section ("AHS"). Mr. Lorenzano presented the testimony of Bobby Lebowsky, the examining auditor. Both parties submitted proposed findings of fact; the facts set forth below constitute the ruling thereon.

The administrative law judge (ALJ) took official notice of all records of the Comptroller's office that pertain to the Petitioner and the issues involved in the case. Unless otherwise indicated, all Section references are to Title 2, Texas Tax Code Ann. (Vernon 1992). References to Rules are to sections of Title 34, Texas Administrative Code.

PETITIONER'S CONTENTION:

Petitioner contends it is not subject to the earned surplus component of the Texas franchise [*2] tax because its activities are protected by 15 U.S.C. Sections 381-384, commonly referred to as Public Law 86-272.

FINDINGS OF FACT:

1. * * * ("Petitioner") is a multi-level marketing and direct sales company with its headquarters located in * * *, Utah. Petitioner maintains no offices or employees in Texas.

2. Petitioner sells nutritional and personal care products throughout the United States, including Texas, as well as numerous foreign jurisdictions.

3. Petitioner sells its products through distributors, who are independent contractors. The distributors are not required to commit to sell exclusively Petitioner's products.

4. Petitioner provides suggested retail prices for its products. However, the price at which Petitioner's products are sold is within the discretion of the distributors.

5. Petitioner's Distributor Manual is the document that controls the agreement between Petitioner and its distributors. In order to become a distributor, a person calls Petitioner's toll-free number to register, completes the Distributor Application and Agreement within 30 days, and pays a non-refundable \$ 20 "start-up" or "sign-up" fee to Petitioner. In return, distributors receive [*3] a Starter Kit, n1 the right to purchase products wholesale from Petitioner, the right to solicit orders for Petitioner's products and services, and the right to participate in Petitioner's Compensation Plan. Under the Compensation Plan, distributors are allowed to sponsor other distributors, and are also eligible to receive bonuses and commission checks from Petitioner. n2 A distributorship is good for one year; distributors must pay Petitioner an annual renewal fee of \$ 20 to maintain their distributorship. Distributors who fail to pay the renewal fee lose all sponsorship rights and wholesale purchasing rights. n3 They also lose the right to use Petitioner's "trademarks, service marks, trade names and any signs, labels, stationery, or advertising referring to or relating to any [Petitioner] product, plan, or program." n4

n1 Per Mr. * * * testimony, the Starter Kit includes a VHS video, as well as promotional and instructional materials.

n2 Petitioner's Distributor Application and Agreement, at MOR-00062; also Petitioner's Distributor Manual, at MOR-00021.

n3 Petitioner's Distributor Manual, at MOR-00010.

n4 Petitioner's Distributor Manual, at MOR-00012.

6. Petitioner's [*4] Distributor Manual provides that participating distributors may sponsor other distributors in any jurisdiction in which Petitioner is open to sponsors. Sponsoring distributors "must ensure that each potential distributor has reviewed and has access to the current policies and procedures and Compensation Plan prior or concurrent to giving the individual an agreement." n5

n5 Petitioner's Distributor Manual, at MOR-00015.

7. Sponsoring distributors are further required to "maintain an ongoing professional leadership association with distributors in his/her organization." They must also "fulfill the obligation of performing a bona fide supervisory, distributor, or sales function in the sale or delivery of products or services." n6 In Mr. * * * words, sponsoring distributors have a responsibility to "teach, train, and motivate other distributors to sell." But Petitioner does not exercise control over how sponsoring distributors carry out this obligation.

n6 Petitioner's Distributor Manual, at MOR-00015.

8. It is to a distributor's benefit to sponsor other distributors. Under Petitioner's Compensation Plan, sponsoring distributors receive commissions and bonuses based upon the sales [*5] of distributors in their organization. Thus, a sponsoring distributor with many distributors "downline" has the potential to substantially increase his/her own commissions and bonuses. Petitioner benefits from this organizational structure as well, through increased sales.

9. Regardless of whether a distributor is part of a sponsoring distributor's organization, each distributor must enter into a Distributor Agreement with Petitioner.

10. When a distributor receives a customer's order, the distributor also accepts the customer's payment, in the form of a cashier's check, money order, personal check, credit card, or debit card. n7 Approximately 95% of orders are paid for by credit card; the distributor takes the customer's credit card information and phones it in to Petitioner, along with the customer's order. Petitioner processes the credit card transactions in Utah against the order.

n7 Petitioner's Distributor Manual, at MOR-00016.

11. As of October 1998, Petitioner had approximately 9,759 distributors located in the state of Texas. n8

n8 Source: The Business Tax Questionnaire completed by Mr. * * * on October 21, 1998.

12. Petitioner's normal practice is to accept and fill [*6] its Texas distributors' orders only from its Utah location. Once Petitioner accepts an order, it ships the product to the Texas distributor or Texas customer through United Parcel Service.

13. Petitioner deviated from this practice, however, in order to facilitate sales in two low-income areas with primarily ethnic populations. As of July 1998, Petitioner maintained a minimal amount of product inventory in * * * and * * *. The inventory, valued at about \$ 600 in each city, was kept at the homes of two of Petitioner's distributors. n9 These individuals held Petitioner's product for sale at retail, in addition to supplying other distributors in their organization. Petitioner allowed this practice in * * * and * * * in order to reduce its distributors' shipping costs. n10

n9 Mr. * * * testified that Petitioner's national and international inventory during the audit period was valued at approximately \$ 9 million.

n10 Mr. * * * testified that the inventory was kept at the distributors' personal residences. In contrast, the AHS argued that the two inventory locations were in business/retail areas. The AHS' Exhibits G and H contain maps of the * * * and * * * areas; the maps show the location of the streets where the inventory was kept, as well as a list of nearby businesses, which are mostly restaurants. The maps do not necessarily contradict Mr. * * * testimony. The AHS' exhibits indicate that the businesses are heavily concentrated on 3 or 4 streets near both the * * * and * * * addresses where Petitioner's inventory was maintained. There are numerous other streets in each neighborhood with no business listings at all. A likely explanation is that both areas are residential, with businesses located on the main thoroughfares. [*7]

14. Petitioner's products come with a customer satisfaction money-back guarantee. If a retail customer is dissatisfied with his purchase, he may return it to the distributor who sold the product. The distributor must provide the customer a full refund. The distributor then returns the unused portion of the product to Petitioner, who provides the distributor with a replacement product.

15. Petitioner's distributors are paid on a weekly commission plan, based upon completed sales. Commission checks are generated from Petitioner's * * * location.

16. In the event that collection action against retail customers is necessary, Petitioner undertakes it. Distributors are not responsible for taking collection action.

17. Petitioner publishes a bi-monthly bulletin that it sends to all distributors. Each bulletin lists meetings scheduled in various jurisdictions, including Texas. Some meetings, including one in * * *, Texas, are on-going, monthly meetings. Petitioner's bulletins also designate certain meetings as "Training meetings," "Opportunity meetings," "Business Builders," "Training Meeting Dist. Only," and "Purchase Required." Distributors sponsor the training meetings. Petitioner may [*8] sponsor other seminars, wherein Petitioner's company executive personnel appear. The purpose of the seminars is to educate potential distributors about Petitioner's company, inform them about the products and Petitioner's marketing plan, and to invite them to share in available business opportunities. n11

n11 Mr. * * * testified concerning one such seminar during the audit period that is known to have occurred in Texas. However, he did not foreclose the possibility that other seminars were held in Texas during the audit period. Petitioner's published bulletins are apparently the best record of all meetings that took place but Petitioner, in response to the AHS' production requests, was able to provide copies of only two such bulletins (for May-June 1997 and May-June 1998).

18. Petitioner charges its distributors a monthly support fee for certain services and reports, described as access to Touch Talk, Distributor Management Report, bulletins, Fax on Demand, recruiting calls, and conference calls. During report year 1997, Petitioner collected \$ 24,640 from its Texas distributors for these fees and reports. Petitioner collected \$ 9,152 in support fees from its Texas distributors [*9] for report year 1998.

19. Petitioner charges its distributors a data processing fee for the issuance of commission checks. During report year 1997, Petitioner collected \$ 2,283.30 in data processing fees from its Texas distributors. For report year 1998, Petitioner collected \$ 4,546.80 in data processing fees from its Texas distributors.

20. During report year 1997, Petitioner collected \$ 79,331 in "start-up" or "application" fees from its Texas distributors. n12 Petitioner collected \$ 81,830 in start-up and renewal fees from its Texas distributors for report year 1998.

n12 Mr. * * * I testified that during the audit period, the fee was \$ 20. This record contains at least two different versions of Petitioner's "Distributor Application and Agreement." One of the applications provides that an applicant must pay \$ 15 for a starter kit. In the other one, the applicant agrees to pay a \$ 25 non-refundable "sign-up fee," which includes a "complimentary" Starter Kit. The Distributor Manual, at MOR-00007, provides that (in some states) the purchase of a Starter Kit is required to become a Distributor.

21. During the audit period, Petitioner engaged the Texas law firm of * * * to perform [*10] professional legal work for Petitioner. At that time, * * * maintained offices in Texas, Oklahoma, and Washington, D.C. * * * reviewed Petitioner's promotional materials that would be distributed nationally and internationally, and assisted Petitioner in settling a suit brought against it by the Texas Attorney General and the attorneys general of other states.

22. * * * a wholly-owned subsidiary of the Petitioner corporation, is a holding company for Petitioner's overseas operations. * * * has no offices or employees in Texas.

23. Petitioner filed Texas franchise tax reports for report years 1997 and 1998. The reports showed no sales in Texas. That is, Petitioner indicated it was not subject to the Texas franchise tax.

24. Based upon Petitioner's activities in Texas, the auditor determined that Petitioner was subject to the Texas franchise tax for report years 1997 and 1998. He therefore made adjustments to Petitioner's Texas and everywhere gross receipts, stated capital, and surplus. For the earned surplus component, the auditor took Petitioner's Texas receipts and divided that number by total gross receipts; he then used federal taxable income and any adjustments thereto, such as [*11] officer and director compensation, special deductions and other qualifying deductions, and Schedule C deductions. In the final analysis, report year 1997 resulted in no tax due, n13 but tax was assessed on the earned surplus factor for report year 1998.

n13 Report year 1997 resulted in no tax due because Petitioner was in a loss position for federal taxable income and Petitioner's taxable capital surplus was a negative number.

CONCLUSIONS OF LAW AND DISCUSSION:

PETITIONER'S CONTENTION:

Petitioner's contention should be denied.

Petitioner argues it has insufficient nexus with Texas to pay the earned surplus component of the Texas franchise tax. Petitioner notes that it has no facilities in Texas, no employees in Texas, nor does it manufacture product in Texas. Rather, as a direct sales multi-level marketing company, Petitioner contracts with independent distributors in Texas, who solicit sales from Texas retail customers. The distributors order all product from Petitioner's Utah headquarters, where the orders are accepted or rejected. Petitioner ships the product to its Texas distributors or Texas customers through a third-party carrier.

Petitioner argues that its activities [*12] in Texas are either limited solely to the solicitation of orders, or are ancillary to such solicitation or de minimus. Training meetings and seminars held in Texas do not create nexus, or are protected activities under Public Law 86-272. Petitioner's sponsorship program is a protected activity because it involves the recruitment and training of additional sales personnel. The application and renewal fees Petitioner charges its distributors are not for the sale of an intangible (a license or a distributorship), but exist to maintain Petitioner's database and to pay postage and other incidental costs associated with soliciting sales. Petitioner also characterizes as de minimus its meetings and seminars held in Texas, its contract for professional legal services with * * *, and its inventory held for sale in Texas. Given the requirements of Rule 3.554 and Public Law 86-272, Petitioner argues it is subject to the taxable capital component of the Texas franchise tax, but not the earned surplus component.

The Administrative Hearings Section ("AHS") argues that Petitioner has sufficient nexus with Texas to justify the audit adjustment to earned surplus. Petitioner's application and renewal [*13] fees charged to Texas distributors are for the sale of an intangible, which is not protected by Public Law 86-272. Maintaining even a minimal amount of inventory in Texas is unrelated to the solicitation of orders. Petitioner furthermore obligated its Texas distributors to sponsor and train other distributors in areas such as business management skills, which is not for the purpose of soliciting orders. The AHS also asserts that the totality of Petitioner's other contacts with Texas -- the meetings/seminars held in Texas on a recurring basis, its contract for professional legal services with a Texas law firm, and the data processing fees and monthly support fees Petitioner collects from its Texas distributors -- are not de minimus, but are sufficient to uphold the franchise tax liability assessed on Petitioner's earned surplus.

As acknowledged by both parties, the AHS bears the initial burden of establishing, prima facie, that the franchise tax assessment was proper. If the AHS makes a prima facie case, the burden shifts to Petitioner to show, by a preponderance of the evidence, that the imposition of the franchise tax was incorrect. Rule 1.40(2)(B), Comptroller Decision No. 29,608 [*14] (1994).

A foreign corporation doing business in Texas is subject to the Texas franchise tax to the extent the tax is not limited by the United States Constitution or federal law. Section 171.001(a)(1) and (c). A foreign corporation must have sufficient contact with this state to be subject to tax. The nexus standards for both the taxable capital component and the earned surplus component of the Texas franchise tax are set forth in administrative rules promulgated by the Comptroller (Rule 3.546 and Rule 3.554, respectively).

The Comptroller has consistently held that foreign corporations who use independent contractors to solicit business in Texas have sufficient nexus for the imposition of the franchise tax. See, Comptroller Decision Nos. 38,070 (2001), 32,017 (1995), as well as earlier Decision Nos. 19,747 (1986), 19,913 (1987), 21,623 (1987), and 18,824 (1987). Petitioner, a foreign corporation, had over 9,000 independent distributors during the audit period operating in Texas that solicited orders for its products. This contact is sufficient to meet the substantial nexus requirements set out in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1997). Petitioner had substantial nexus in Texas for the imposition of the franchise tax.

A foreign corporation doing business in this state may be subject to the taxable capital component of the franchise tax, but not the earned surplus component, because of Public Law 86-272. A foreign corporation would be immune from an assessment against its earned surplus if the only business activity it conducted in Texas was the solicitation of orders for sales of tangible personal property, where the orders are accepted or rejected out-of-state, and also filled or shipped from out-of-state. However, a foreign corporation that leases, rents, licenses, or otherwise disposes of tangible personal property, intangibles, or other types of property would not be protected from taxation under Public Law 86-272.

Rule 3.554(c) defines "solicitation of orders" as "speech or conduct that explicitly or implicitly invites an order" or "activities that are entirely ancillary to requests for an order." Ancillary activities are "activities that serve no independent business function for the seller," which the seller would engage in apart from the solicitation of orders. Public Law [*16] 86-272 protects only ancillary activities that facilitate the requests for an order, not activities that facilitate sales. However, if the disqualifying activities, taken together, are de minimus, the taxpayer will not lose the exemption afforded by Public Law 86-272. n14 De minimus activities are those that "establish only a trivial additional connection" with the state. Regularly-conducted activities in the state that occur pursuant to the taxpayer's company policy or on a continuous basis will not be considered trivial. Rule 3.554(c)(3). In deciding whether an activity creates a non-trivial connection with Texas, the Comptroller will consider both qualitative and quantitative measures. Rule 3.554(d) provides a long list of specific activities which, if conducted by a foreign corporation in Texas on greater than a de minimus level, will constitute doing business in Texas. Some of the disqualifying activities listed in Rule 3.554(d) are "collecting current or delinquent accounts," "owning...[or] maintaining...[a] stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation," "conducting any activity listed as doing business in [Rule] 3.546 [*17] [Taxable Capital: Nexus]...which is not protected by Public Law 86-272," and "conducting any activity not listed in [Rule 3.554(e)] which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases." n15

n14 The Supreme Court case that established these principles is *Wisconsin Dept. of Revenue v. Wrigley Co.*, 505 U.S. 214 (1992).

n15 Rule 3.554, subsections (d)(2),(d)(16)(G), (d)(20), and (d)(21).

Rule 3.546 lists, in part, the following activities which constitute doing business in Texas that are not protected by Public Law 86-272: contracting (performance of a contract in Texas) by hiring local labor, providing services in Texas even if the employees, independent contractors, agents, or other representatives performing the services reside in Texas, and having spot inventory in Texas for the convenient delivery to customers, even if the bulk of orders are filled outside the state.

Examples of protected activities listed in Rule 3.554(e) include soliciting orders for sales by advertising, carrying samples for purposes of display and distribution without consideration, missionary sales activities, and recruitment, training, or evaluation [*18] of sales personnel, including occasional use of homes, hotels, or similar places for meetings. n16

n16 Rule 3.554, subsections (e)(1), (e)(2), (e)(5), and (e)(9).

Finally, Rule 3.554(f) protects certain activities conducted by independent contractors that, if conducted by the foreign corporation or its agents or other representatives, would exceed the protection of Public Law 86-272. Independent contractors may solicit sales, make sales, and maintain an office in Texas without the foreign corporation's loss of immunity. However, having an independent contractor who maintains a stock of goods in Texas under anytype of arrangement with the foreign corporation, except for purposes of display and solicitation, will result in a loss of immunity.

How has the Comptroller interpreted the provisions of Public Law 86-272? In Decision No. 38,070 (2000), the taxpayer was a foreign corporation who sold nutritional and personal care products in Texas through independent contractors. All orders were filled and shipped from out-of-state. The taxpayer's Texas distributors participated in a sponsorship program (very similar to Petitioner's Compensation Plan) that included commissions and royalties. [*19] The distributors were not required to pay application and renewal fees, but were required to purchase a "Distributor Kit" from the taxpayer that included its products in saleable form, priced at \$ 50 to \$ 60. The taxpayer charged its distributors an "annual processing fee," but this fee was not routinely paid. The taxpayer's sponsoring distributors had supervisory and training responsibilities toward downline distributors, and in addition, sponsoring distributors were required to intervene in customer and distributor disputes. The Comptroller found that the activities of the taxpayer's distributors were limited solely to the solicitation of sales, were entirely ancillary to such solicitation, or were de minimus. Thus, the taxpayer in Decision No. 38,070 was not subject to the earned surplus component of the Texas franchise tax.

There are a number of facts that distinguish Petitioner's circumstances from those of the taxpayer in Decision No. 38,070. Unlike Petitioner, the taxpayer in Decision No. 38,070 collected no application or renewal fees from its Texas distributors, took no collection action in Texas, maintained no inventory in Texas, entered into no contracts in Texas, and collected [*20] no data processing fees or other support fees from its Texas distributors. Facts 5, 10, 13, 16, 18, and 19. The taxpayer's distributors were also not required to make refunds to customers, in contrast to Petitioner's distributors. Fact 14.

In Decision No. 35,026 (1997), the taxpayer was a foreign corporation that sold houseware products in Texas through distributors (who were not really independent contractors because they were limited to selling the taxpayer's products). All orders were filled and shipped by from out-of-state. Again, the distributors participated in a sponsorship program that included financial incentives, in addition to responsibilities including the training of downline distributors, taking care of disputes in the field, resolving customer complaints, and servicing the products sold by the taxpayer. The ALJ in Decision No. 35,026 found that the following activities of the taxpayer's distributors were not "solicitations for orders" or "ancillary to the solicitation of orders:" 1) sponsoring distributors teaching other distributors recruiting, training, motivation, and business management skills; 2) sponsoring distributors assisting downline distributors with problems [*21] beyond their experience; 3) sponsoring distributors performing activities such as detecting difficult situations that could adversely affect the company and advising management of same; 4) distributors in some instances collecting money from customers; and 5) distributors returning down payments directly to the customer. The ALJ noted that these activities were regularly conducted in Texas pursuant to the taxpayer's company policy. The ALJ found that the taxpayer's non-protected activities in Texas, taken together, did not meet the de minimus test set forth in *Wrigley*. The taxpayer was consequently subject to the earned surplus component of the Texas franchise tax.

Similar to the taxpayer in Decision No. 35,026, Petitioner's company policy requires its distributors to provide refunds directly to their customers. Fact 14. Petitioner's distributors also, in some instances, collect the customers' payments. Fact 10. However, unlike the taxpayer in Decision No. 35,026, Petitioner's distributors are truly independent contractors n17 for purposes of Rule 3.554(f); therefore "recruitment, training, or evaluation of sales personnel,

including occasional use of homes, hotels, or similar [*22] places for meetings with sales personnel" is an activity protected by Public Law 86-272.

n17 Section 101(d)(1) of Public Law 86-272 defines an independent contractor as "a commission agent, broker, or other independent contractor who is engaged in selling or soliciting orders for the sale of tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities...". * * * testimony. The AHS' exhibits indicate that the businesses are heavily concentrated on 3 or 4 streets near both the * * * and * * * addresses where Petitioner's inventory was maintained. There are numerous other streets in each neighborhood with no business listings at all. A likely explanation is that both areas are residential, with businesses located on the main thoroughfares.

<17> Mr. * * * testified concerning one such seminar during the audit period that is known to have occurred in Texas. However, he did not foreclose the possibility that other seminars were held in Texas during the audit period. Petitioner's published bulletins are apparently the best record of all meetings that took place but Petitioner, in response to the AHS' production requests, was able to provide copies of only two such bulletins (for May-June 1997 and May-June 1998).

<17> Mr. * * * testified that during the audit period, the fee was \$ 20. This record contains at least two different versions of Petitioner's "Distributor Application and Agreement." One of the applications provides that an applicant must pay \$ 15 for a starter kit. In the other one, the applicant agrees to pay a \$ 25 non-refundable "sign-up fee," which includes a "complimentary" Starter Kit. The Distributor Manual, at MOR-00007, provides that (in some states) the purchase of a Starter Kit is required to become a Distributor.

<17> Report year 1997 resulted in no tax due because Petitioner was in a loss position for federal taxable income and Petitioner's taxable capital surplus was a negative number.

<17> The Supreme Court case that established these principles is *Wisconsin Dept. of Revenue v. Wrigley Co.*, 505 U.S. 214 (1992).

<17> Rule 3.554, subsections (d)(2),(d)(16)(G), (d)(20), and (d)(21).

<17> Rule 3.554, subsections (e)(1), (e)(2), (e)(5), and (e)(9).

<17> Section 101(d)(1) of Public Law 86-272 defines an independent contractor as "a commission agent, broker, or other independent contractor who is engaged in selling or soliciting orders for the sale of tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities...". [*23]

One other Comptroller Decision interpreting nexus requirements and the earned surplus component of the Texas franchise tax should be noted, although the factual situation involved is dissimilar to the one here. Decision No. 34,833 (1997) concerned a Wisconsin corporation that arranged professional education seminars in Texas. The taxpayer solicited a Texas audience by mail, secured appropriate facilities such as hotels for the seminars held in Texas, and contracted with a Texas firm to provide temporary support services (preparing the written materials) for the seminars. Attendees mailed their payments to the taxpayer in Wisconsin. The taxpayer did not send its employees to the seminars in Texas, but did pay speakers to appear. Although the taxpayer's books and audiotapes were advertised in the seminar materials, and were available to attendees by mail, these items were not displayed or sold at the seminars. The ALJ in Decision No. 34,833 found that: 1) conducting educational seminars was unrelated to the solicitation of orders for tangible goods; 2) arranging and presenting seminars through paid speakers was not ancillary to the taxpayer's mail order solicitations; and 3) contracting [*24] with a Texas firm for support services was not ancillary to the taxpayer's solicitations, because this activity served an independent business function. The activities were also not de minimus because they occurred pursuant to a company policy or on a regular basis. The ALJ concluded that Public Law 86-272 did not protect the taxpayer's activities, thus the disputed assessment against earned surplus was proper.

Based upon the requirements of Public Law 86-272 and Rule 3.554, as well as the holdings in the relevant Comptroller decisions, I conclude that certain of Petitioner's activities in Texas exceed the protection of Public Law 86-272.

Petitioner generated over \$ 160,000 in income during the audit period through application and renewal fees collected from its Texas distributors. Fact 20. The AHS argues these fees were for the sale of an intangible (a distributorship), although Petitioner insists the fees were used to cover administrative costs associated with operating a multi-level marketing business. In any event, it seems clear that the application and renewal fees were not related to the

solicitation of orders, nor were they ancillary to the solicitation of orders. Likewise, [*25] the data processing fees and other support fees Petitioner collected from its Texas distributors were not connected to the solicitation of orders. Facts 18 and 19.

Petitioner also maintained inventory in Texas, albeit a minimal amount when compared to its total inventory. Fact 13. Maintaining a "stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation" constitutes doing business in Texas. Rule 3.554(d)(16)(G). A taxpayer is also doing business in Texas for purposes of the earned surplus component if it conducts any activity listed in Rule 3.546(c); one of the activities listed there is "having an inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state." Additionally, an independent contractor who maintains a stock of goods in Texas under any arrangement with the company, except for purposes of display and solicitation, will exceed the protection afforded by Public Law 86-272. Rule 3.554(f)(3).

The facts surrounding Petitioner's debt collection activities in Texas are sketchy. Fact 16. However, Mr. * * * testified that Petitioner, not its distributors, [*26] was responsible for undertaking collection action against retail customers who failed to meet their obligations. Collecting current or delinquent accounts in this state constitutes doing business in Texas for purposes of the earned surplus component of the franchise tax. Rule 3.554(d)(2). Debt collection is furthermore unrelated to the solicitation of orders. Public Law 86-272 does not protect this activity.

Petitioner's distributors were required, pursuant to company policy, to make refunds directly to Texas customers. Fact 14. Again, this activity is not connected to the solicitation of orders, nor is it ancillary to the solicitation of orders.

The last contact of significance is Petitioner's contract for professional legal services with * * *, a Texas law firm. Fact 21. A taxpayer that enters into a contract with a Texas vendor, for a service that is provided in Texas, is doing business in Texas. See Rule 3.554(d)(20) and 3.546(c)(1).

The above-referenced activities conducted by Petitioner in Texas exceed the protection of Public Law 86-272. Moreover, the activities, when taken together, are not de minimus. It is true that the amount of inventory Petitioner maintained in Texas [*27] was minimal, when compared with its total inventory. Nonetheless, the evidence indicates that holding this inventory in Texas was a conscious sales strategy Petitioner undertook in order to reach customers in low-income areas and to reduce its distributors' shipping costs, thereby increasing sales. Furthermore, pursuant to its company policy, Petitioner consistently collected the application and renewal fees, data processing fees, and monthly support fees from its Texas distributors. Petitioner's Texas distributors also routinely provided customer refunds. Petitioner's debt collection activities in Texas were most likely performed as the need arose. While I agree with Petitioner that its contract with a Texas law firm, by itself, would constitute a trivial additional connection with Texas, the non-protected activities must be considered together. Petitioner's disqualifying activities in Texas as a whole were not de minimus.

In summary, Petitioner has substantial nexus in Texas for the imposition of the franchise tax. Certain of its activities in Texas exceed the protection afforded by Public Law 86-272, because they are neither the solicitation of orders nor ancillary to the solicitation [*28] of orders. Petitioner's disqualifying activities, taken together, also establish more than a trivial additional connection with Texas, so they are not de minimus. Petitioner is therefore subject to the earned surplus component of the Texas franchise tax.

RECOMMENDATION:

Based upon the findings of fact, conclusions of law, and discussion contained herein, the ALJ recommends that the audit liability be upheld.

SIGNED October 21, 2002.

ORDER OF THE COMPTROLLER

The above decision of the Administrative Law Judge, resulting in Taxpayer's liability as set out in Attachment "A" which is incorporated by reference, is approved and adopted in all respects. This decision becomes final twenty-three (23) days from the date of this Order, and the total sum of the tax, penalty, and interest amounts is due and payable within twenty (20) days thereafter. If such sum is not paid within such time, an additional penalty of ten percent of the taxes due will accrue, and interest will continue to accrue.

If a rehearing is desired, a Motion for Rehearing must be filed with the Administrative Law Judge no later than twenty-three (23) days after the date of this Order, and must state the [*29] grounds upon which the motion is based.

RENDERED and ISSUED October 21, 2002.

CAROLE KEETON RYLANDER, Comptroller of Public Accounts of the State of Texas

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