



SC PRIVATE LETTER RULING #88-19

TO: XYZ Corporation

SUBJECT: Income Tax/Activities Exceeding Solicitation
Standard in P.L. 86-272

REFERENCE: 15 U.S.C. 381, P.L. 86-272
S.C. Code Ann. Section 12-7-230 (Supp. 1987)
S.C. Code Ann. Section 12-7-250 (Supp. 1987)

AUTHORITY: S.C. Code Ann. Section 12-3-170 (1976)
S.C. Revenue Procedure #87-3

SCOPE: A Private Letter Ruling is a temporary document issued to a taxpayer, upon request, and it applies only to the specific facts or circumstances related in the request. Private Letter Rulings have no precedential value and are not intended for general distribution.

Question:

1. Are the combined activities of both the Professional Division and Consumer Products Division of XYZ within the P.L. 86-272 definition of "solicitation" as that term is interpreted by the South Carolina Tax Commission?
2. If the aforementioned activities of XYZ were deemed not to create nexus under South Carolina law but XYZ was legally qualified to do business within the state, would XYZ
 - a. Not have to file a return?
 - b. Be required to file a return with only a minimum tax due?
 - c. Be required to file a return based only upon the apportioned net worth and/or net income of XYZ?

Facts:

XYZ is a corporation organized and existing under the laws of the State of Delaware. Its main offices are located in another state. XYZ is a pharmaceutical company which manufactures

drugs and distributes them throughout the United States. As the result of a reorganization pursuant to the requirements of Sections 351, 368(a)(1)(D) and 355 of the Internal Revenue Code of 1954, as amended, XYZ transferred out of its corporate entity a division which maintained inventory in several states. In reviewing the corporate structure as it now exists, there is a question as to whether the new corporate structure (without the aforementioned transferred division) would have nexus for state corporate income and/or franchise tax purposes.

XYZ is divided for marketing purposes into two segments, a Professional Division and a Consumer Products Division. The Professional Division markets only ethical pharmaceuticals, i.e., drugs dispensed solely on the prescription of a physician. The Consumer Products Division markets only those drugs which are capable of being sold legally without a prescription or, as they are more commonly known, over-the-counter drugs.

Each of the aforementioned divisions has personnel performing various solicitation activities within South Carolina. With the exception of these personnel, XYZ has no other presence within the State. The following describes the in-state activities of each respective division.

XYZ's Professional Division representatives visit physician's offices, hospitals, clinics and nursing homes in their assigned area. The representatives explain the therapeutic value of XYZ's products to physicians and pharmacists. They tell what the product is, what it will do, what dosage is desirable and what its side effects might be. Literature is available and often left with the doctors and pharmacists along with samples of XYZ's products.

On approximately a quarterly basis, area representatives visit local pharmacies to inform them of special promotional deals normally received only by independent wholesalers. If a pharmacy orders a certain amount of a XYZ product from the independent wholesaler, the representative will write up the order, send it to the independent wholesaler and then give the pharmacy an immediate rebate of a portion of the price charged by the independent wholesaler as authorized and determined by written instructions received from corporate headquarters in New Jersey. To pay this rebate, the representative will write a check from a XYZ New Jersey bank account made out to the pharmacy. At all other times of the year, the pharmacies will only order directly from the independent wholesaler with no contact from the area representatives.

The Professional Division representatives work out of their homes with no reimbursement for rooms or space utilized. XYZ leases automobiles for the representatives and provides reimbursement for certain incidental business expenses. The company may provide the representative with a nominal sales aid such as a tape recorder. When visiting both potential and prior customers, representatives carry only literature and samples. Samples are replenished quarterly. The manner in which samples are stored until distributed is left to the discretion of the individual representative. While they may be stored in the representative's residence, if the representative chooses to rent self-storage space in his own name, XYZ will reimburse the representative for expenses incurred to store the samples. XYZ asserts that representatives solicit orders but do not have the power to accept or reject such orders. XYZ states that this authority lies solely with corporate headquarters in New Jersey. The representatives do not maintain any inventory and do not make "on the spot" sales with the samples. All South Carolina shipments originate from inventory stored outside South Carolina. The representatives

do not set up equipment, assist in promotions or arrange displays. Representatives do check inventories in both hospitals and warehouses recommending a proper level of inventory to maintain. Prices are set by corporate headquarters and are non-negotiable. Representatives cannot grant credit. These activities can only be performed by employees at the corporate headquarters. In addition, representatives do not accept customer payments. If there are customer inquiries, delays in shipments or damaged goods, customers must call corporate headquarters. All representative education, training and instructional services are performed at the corporate headquarters in New Jersey.

The Consumer Products Division has four different types of representatives within South Carolina: independent brokers, broker managers, national account managers and professional sales representatives.

Brokers are fully independent contractors who represent XYZ and other companies. They solicit orders for XYZ but lack the authority to accept or reject such orders. They are compensated only on a commission basis. Broker managers are employees who direct the independent brokers. Broker managers are provided with automobiles leased by XYZ and are reimbursed for certain incidental business expenses. Managers will oversee the solicitation activities of the independent brokers in the solicitation process when they are calling upon customers but they neither solicit nor accept orders nor do they grant credit.

There are three national account managers who operate on a nationwide basis and who deal solely with major drug/pharmaceutical houses. Each manager is responsible for approximately three or four accounts. Their role is to set up and coordinate the specifics of promotional programs with the major customers who are on a direct purchase program with XYZ corporate headquarters in New Jersey. They direct the buyer in terms of nationwide marketing strategies for XYZ products by the respective warehouse as opposed to writing orders for new business.

The last category of representative, the professional sales representative, operates in a manner similar to that of the Professional Division representatives. It is their responsibility to call upon both family practitioners and pediatricians to inform them of the various components of XYZ Consumer Products Division product line. They do not solicit nor write up orders. They merely encourage the use of XYZ products before a sale is made and leave both samples and literature with the physician.

Discussion:

1. Public Law 86-272, as codified at 15 U.S.C. Section 381, provides in pertinent part as follows:
 - (a) No state or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax 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:

- (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 out-side the state; ***.

The critical element in this case is whether XYZ's activities go beyond the term "solicitation of orders." Although some courts have adopted a broad meaning to this term and thus excluded the income from taxation, South Carolina has held that a narrow construction is appropriate. (Tax Commission Finding dated 3-25-85)

Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), found that due process did not limit the state's right to tax a corporation where the corporation has engaged in substantial income producing activities in the state. Section 381 is a congressional limitation upon the broad reach of due process with such limitation prohibiting taxation where the only activity is solicitation. Such a limitation in effect is a federal restriction of the broad power of the state to tax. A restriction upon the state's fundamental power to tax is a shift in Federal-State relations. Unless Congress "conveys its purpose clearly it will not be deemed to have significantly changed the Federal-State balance." United States v. Bass, 404 U.S. 336 (1971). Thus, solicitation is more properly read narrowly so as not to infringe upon the state's ability to tax.

In this case, XYZ's presence in South Carolina exceeds solicitation in several instances. It is well recognized that a representative's acceptance of orders exceeds the realm of solicitation. (P.L. 86-272 Section 101(a)(1)). Here, XYZ's area representatives of the Professional Division visit local pharmacies to inform them of special promotional deals normally received only by independent wholesalers. If a pharmacy orders a certain amount of a XYZ product from the independent wholesaler, the representative will write up the order, send it to the independent wholesaler, then give the pharmacy an immediate rebate of a portion of the price charged by the independent wholesaler. This rebate is given in the form of a check written by the representative from a XYZ New Jersey bank account. The procedure outlined here is tantamount to the acceptance of an order by the representative on behalf of the wholesaler.

XYZ also utilizes broker managers who oversee and direct the activities of independent brokers. William Wrigley, Jr. Co. v. Wisconsin Department of Revenue, Docket Number I-8591, held that the hiring, training, or supervising of personnel exceeds solicitation. In doing so, the Wisconsin Tax Appeals Commission adopted Multistate Tax Commission Resolution 1985-4 defining the scope of solicitation into immune and non-immune activities. This resolution specifically enumerates the hiring, training or supervising of personnel as a non-immune activity and therefore taxable. This approach is consistent with South Carolina's narrow interpretation of the term "solicitation."

The activities of the national account managers of the Consumer Products Division also appear to be outside of the protected activities of P.L. 86-272. Their role is to set up and coordinate the specifics of promotional programs with major customers on direct purchase with New Jersey. They direct customers in terms of marketing strategies for XYZ products as opposed to soliciting orders.

P.L. 86-272 immunity was denied in Clairol v. Kingsley, 262 A. 7d 213, aff'd, 270 A. 2d 702 (1970), dismissed for want of substantial question, 91 S.Ct. 1337, 28 L.Ed. 2d 643 (1971). Clairol's representative whose primary function was "to promote the public's purchase and use of its products," made regular visits to retail druggists, reviewing displays, arranging promotions and suggesting optimum ways to merchandise Clairol products. Clairol's representatives also carried promotional material, business forms and samples. On occasion, they also took inventory of a store's stock of Clairol products, suggested orders based on their findings. Further Clairol employed technicians in New Jersey to instruct its customers in how to use its products. Without deciding whether, without the technicians, Clairol's activities went beyond solicitation, the New Jersey Superior Court concluded that when taken as a whole, Clairol's activities went beyond solicitation as defined by P.L. 86-272.

Likewise, the activities of XYZ within South Carolina go beyond solicitation as defined by P.L. 86-272.

2. Since XYZ has exceeded solicitation and is therefore deemed to have nexus in South Carolina, the second question is moot. However, if the activities of XYZ did not exceed mere solicitation and XYZ was legally qualified to do business in South Carolina, a return would be required to allow XYZ to file an annual report and pay the corporate license fee. Section 12-19-20 requires every corporation organized to do business in another state and qualified to do business in South Carolina to file an annual report. The license fee is imposed under Section 12-19-70 upon every corporation required to file an annual report. XYZ's license fee base would be apportioned based upon the income tax apportionment ratios although no income tax would be imposed.

Conclusion:

The combined activities of both the Professional Division and Consumer Products Division of XYZ fall outside of the P.L. 86-272 definition of solicitation" as that term is interpreted by the South Carolina Tax Commission.

However, if XYZ reduces its activities to mere solicitation, XYZ would be required to make an annual report and pay the corporate license fee.

SOUTH CAROLINA TAX COMMISSION

s/S. Hunter Howard Jr

S. Hunter Howard, Jr., Chairman

s/A. Crawford Clarkson Jr.

A. Crawford Clarkson, Jr., Commissioner

Columbia, South Carolina
September 21 _____, 1988