



Volume 12 Number 10

October 2005

State Tax Return

The "ABC's" And "XYZ's" Of Affiliate Nexus In Pennsylvania

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The Pennsylvania Department of Revenue (the "Department") recently issued a letter ruling on the subject of affiliate nexus. In Legal Letter Ruling No. CRP-05-003 (Pa. Dept. of Rev. August 5, 2005), the Department concluded that an out-of-state limited liability company (the "taxpayer") was subject to franchise tax because an affiliated corporation will perform solicitation activities on its behalf in Pennsylvania.

The Taxpayer has no employees, business location or other physical presence in Pennsylvania. Although the Taxpayer itself conducts no business activities in Pennsylvania, three of its affiliates will be located in Pennsylvania and will perform various activities for the Taxpayer there. These corporations were designated "Company X," "Company Y" and "Company Z." The Department reviewed the operations of each of these affiliates and concluded that only Company Z's activities will create corporate tax obligations for the out-of-state Taxpayer.

Management Services Will Not Create Nexus

Company X is affiliate of the taxpayer and will be located in Pennsylvania. For an arms-length fee, Company X will provide the Taxpayer with management and corporate shared services. The Department concluded that although the affiliate will be performing activities on behalf of the Taxpayer in Pennsylvania, it would not be acting as the Taxpayer's agent or representative. As a result, Company X's activities will not create any corporate tax obligations for the Taxpayer.

Development Services Will Not Create Nexus

Company Y is also an affiliate of the Taxpayer and will likewise be located in Pennsylvania. It will provide pharmaceutical development services to the Taxpayer in Pennsylvania. Like Company X, Company Y will also charge the Taxpayer an arms'-length fee for its services, to be determined on a cost-plus basis. The Department similarly concluded that these activities will not create tax obligations for the out-of-state affiliate.

Sales Solicitation Activities Will Create Nexus

The Taxpayer's luck ran out with Company Z, an affiliate that will solicit sales in Pennsylvania. The product inventory that is the subject of these sales is owned and held by the Taxpayer at its out-of-state warehouse. The Taxpayer sells these products to Company Z pursuant to a Product Sales Agreement, and then ships the products directly from its out-of-state warehouse to Company Z's customers. The Department concluded that the Taxpayer was subject to franchise tax in Pennsylvania because Company Z solicited sales on its behalf.¹

If Company Z does solicit sales on behalf of the Taxpayer, it is clear that adequate tax nexus would exist. See, e.g. *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) and *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 US 232; 107 S Ct 2810; 97 LEd 2d 199 (1987). However, the nature of the business relationship between the parties is not clear. Although Company Z will be soliciting sales in Pennsylvania, it is not clear if this sales solicitation is done on its own behalf or on behalf of the Taxpayer.

The Agreement between the parties is silent on this critical point. The Department assumes that Company Z will solicit sales on behalf of the Taxpayer.² The factual description presented in the ruling, however, suggests that the Taxpayer is operating as a wholesaler/drop shipper for Company Z in connection with *Company Z's* sales to end-users. If so, Company Z's sales solicitation activities should have no bearing on the Taxpayer's tax obligations. Only those activities conducted *on behalf of* an out-of-state taxpayer may be considered for purposes of determining tax nexus.

Conclusion

Not all activities performed on behalf of an out-of-state company create corporate tax obligations. In this case, the Pennsylvania Department of Revenue concluded that the management services and other research/development services performed by the Taxpayer's affiliates in Pennsylvania would not subject it to corporate income or franchise tax obligations there.

By contrast, the Department did find that Company Z's solicitation activities created franchise tax obligations for the affiliated Taxpayer. Unlike the management and development activities performed by Companies X and Y, the Department found that activities performed on the Taxpayer's behalf by Company Z created and maintained a

¹ Public Law 86-272 would protect the taxpayer from income tax obligations in Pennsylvania, assuming that Company Z's activities on the taxpayer's behalf did not exceed solicitation.

² In this regard, the Department notes that:

Company Z is the parent and Taxpayer is the subsidiary. If Company Z were soliciting sales on its own behalf, the amount of Taxpayer's payment to Company Z would not be dependent upon the solicitation activities of Company Z. Therefore, Company Z is soliciting sales of Taxpayer's products on behalf of Taxpayer.

market for the Taxpayer in Pennsylvania. As a result, the Taxpayer was subject to franchise tax in Pennsylvania. ■



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