ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING O5-001

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TO: Parent Incorporated

FROM: G. Thomas Surtees
Commissioner of Revenue

DATE: April 7, 2005

SUMMARY OF THE RULING

Currently, Wholesale has nexus with Alabama for income tax and business privilege tax purposes. The Sales Group has nexus with Alabama for purposes of the business privilege tax. Parent's licensing of intangible property to Subsidiaries, which use it in Alabama, creates nexus for Parent for corporation income tax and business privilege tax purposes.

The proposed future activities in Alabama by Retail will create nexus for the Sales Group for use tax and income tax purposes.

FACTS AS RELATED BY REQUESTOR

1. Description of Parent's Business Operations.

Parent Incorporated (Parent) is the holding company for its wholly owned subsidiaries (the Subsidiaries) and it also owns trademarks, which it licenses to the Subsidiaries for an annual fee. Each of the Subsidiaries pays Parent to lease space in Parent's headquarters building in State X. Each of the Subsidiaries also pays Parent to receive certain services, including the following:

- Accounting Services. These include preparation of financial statements and tax returns, cash management services, payroll services and budgeting and long-term planning. It is necessary that the financial information of Parent and the Subsidiaries (collectively, the Consolidated Group) be combined for purposes of reporting to shareholders and filing reports with governmental and regulatory authorities (including federal and certain state income tax returns). Parent pays all taxes due from each Subsidiary and each Subsidiary reimburses Parent for such payments.

- Management Information Services. These include, without limitation, providing Internet and LAN access to the Subsidiaries and consultation and assistance in maintaining and upgrading the computer systems in the Retail Centers and the Distribution Centers (defined below).

- Risk Management Services. These include negotiating and obtaining for the Subsidiaries property, casualty and general liability insurance and workers' compensation insurance (this is done at the Parent's level to take advantage of group discounts); providing consultation and

assistance on safety and loss prevention programs; and complying with all rules of federal, state and local regulatory agencies.

- Human Resources Services. These include consultation and assistance on hiring decisions; training of management-level employees; and employee benefits administration and compliance with all applicable federal, state and local laws.

- Executive Services. These include the services of Parent's in-house counsel and/or other officers of Parent who may provide consultation and assistance to one or more Subsidiaries with respect to Parent's policies or procedures, reporting requirements or other matters.

- Strategic Project Management. These include the services of Parent's employees, who provide consultation and management services in connection with certain projects undertaken by the Subsidiaries, such as the development of new Retail Centers and Distribution Centers.

The licenses, leased space and all services are provided by Parent to the Subsidiaries pursuant to intercompany agreements and for sufficient consideration.

Parent does not have physical facilities, employees or independent contractors in Alabama. Parent does not hold trade shows, store inventory, hold merchandise or lease or maintain any other property, real or personal, within Alabama. Parent does not have bank accounts in Alabama or employ persons within Alabama to collect overdue accounts. Parent does not have a Certificate of Authority to transact business in Alabama.

2. Description of the Sales Group's Business Operations.

a. Mail Order. Mail Order maintains its headquarters in State X. It mails Catalogs to State X and non-State X residents (including Alabama residents) who place orders for its products by mail, telephone and facsimile transmission. Pursuant to an intercompany agreement between Mail Order and Dotcom, orders may also be placed on the Site (as defined in subsection (b) below); the prospective customer identifies each product by referencing a product number contained in a Catalog, thus enabling Dotcom to separately track sales attributable to Mail Order. Mail Order periodically advertises the Catalogs on cable television and in print media, providing a toll-free number to call to order Catalogs. Mail Order approves or rejects orders received from Alabama residents at its headquarters in State X, and pursuant to an intercompany agreement with Wholesale, instructs Wholesale to ship products to Alabama residents. Wholesale either ships products via common carrier or the U.S. Postal Service, or instructs vendors with which it has established a "drop shipment" relationship to ship the products.

b. Dotcom. Dotcom also maintains its headquarters in State X. Dotcom accepts orders from State X and non-State X residents (including from Alabama residents) who place orders for its products over the Internet using Dotcom's online order system located on its web site, (the "Site"). Dotcom periodically advertises its products and services on cable television and in print media, and provides the URL for the Site on such advertisements. Pursuant to an intercompany agreement between Mail Order and Dotcom, the URL for the Site is also included

in the Catalogs and Dotcom purchases Catalogs from Mail Order which are provided upon request to visitors to the Site. Dotcom approves or rejects orders received from Alabama residents at its headquarters in State X, and pursuant to an intercompany agreement with Wholesale, instructs Wholesale to ship products to Alabama residents. Wholesale either ships products via common carrier or the U.S. Postal Service, or instructs vendors with which it has a "drop shipment" relationship to ship the products. There is no advertising of the Site in the Retail Centers.

c. Mail Order II. Mail Order II sells products through its own catalogs, at its retail locations in State Y and to licensees who desire to create their own reproductions. Sales are made to Alabama residents. Pursuant to an intercompany agreement, Mail Order II also sells products to Wholesale for resale to Mail Order, Dotcom, Retail and Marketing. Mail Order II selects the suppliers from whom it will acquire the right to make and sell a limited number of products. Mail Order II stores the products at its headquarters/operational facility in State Y. Mail Order II is a limited liability company owned by Retail.

d. Mail Order III. Mail Order III maintains its headquarters and operational facilities in State Z. It mails catalogs to State Z and non-State Z residents (including Alabama residents), who place orders for its products and supplies by mail, telephone and facsimile transmission. These items can also be purchased from Mail Order III's web site. Mail Order III approves or rejects orders received from Alabama residents at its headquarters in State Z, and ships products to Alabama residents via common carrier or the U.S. Postal Service.

e. Marketing. Marketing maintains its headquarters in State X. Marketing designs incentive programs for businesses to use in rewarding employees, customers and business associates. The incentives are in the form of gift certificates or prepaid "gift cards" (herein collectively the "Gift Certificates") or discounted prices on specialized products ordered in large quantities. Pursuant to an intercompany agreement between Marketing, Mail Order, Retail and Dotcom, the Gift Certificates can be presented at a Retail Center, used to purchase products from Catalogs or used to purchase products online. Marketing receives payment for the Gift Certificates from its customers and then reimburses Mail Order, Retail or Dotcom, as the case may be, when the Gift Certificates are redeemed. Marketing also contracts with businesses to embroider their names (or their employees' names) and/or logos on clothing and offers a "corporate incentives" program that is suitable for use in providing incentives to employees, customers and business associates. Marketing has contracted with Alabama businesses to provide the incentive, clothing and gift programs described in this paragraph. Marketing also sells products to federal, state and local governmental entities that utilize special purchasing and payment systems and often buy in bulk quantities entitling them to special discounts. Marketing has contracted with governmental entities in Alabama.

Marketing markets the incentive/gift programs described above and its government sales programs via its own separate catalogs and call center representatives. It approves or rejects contracts and/or orders from Alabama at its headquarters in State X. Products are shipped to Alabama residents, businesses and/or governmental entities from outside Alabama via common carrier or the U.S. Postal Service. Pursuant to intercompany agreements with Mail Order and Dotcom, Marketing also advertises in the Catalogs and on the Site.

No member of the Sales Group has physical facilities, retail outlets, employees or independent contractors in Alabama. None holds trade shows, stores inventory, holds merchandise, or leases or maintains any other property, real or personal, within Alabama. None has bank accounts in Alabama or employs persons within Alabama to collect overdue accounts. None holds an Alabama sales tax license or has a Certificate of Authority to transact business in Alabama.

3. Description of Retail's Business Operations.

Retail maintains its headquarters in State X. It operates Retail Centers in several states. Retail intends, subject to the satisfaction of certain conditions, to acquire property to develop an Alabama Retail Center.

Retail purchases Catalogs from Mail Order and places them in the Retail Centers pursuant to an intercompany agreement entered into between the parties. However, the Catalogs are not displayed to the general public, but rather, are available only upon customer request. The Catalogs are used by customers as educational tools/sales guides. Because both entities sell products, prospective customers may prepare for a visit to a Retail Center by reviewing the product descriptions in the Catalogs. Occasionally, if an item is out of stock in a Retail Center, a Retail Center employee places an order with Wholesale, and Wholesale then ships the item to the customer requesting it. Each of Retail, Mail Order, Dotcom and Marketing sells Gift Certificates. Pursuant to an intercompany agreement between these entities, the holder of a Gift Certificate may present it at a Retail Center or use it to purchase products from Catalogs or the Site. The entity which sold the Gift Certificate must pay the redeeming entity for the retail price of the merchandise delivered in exchange for the Gift Certificate.

4. Description of the Wholesale's Business Operations.

Wholesale was formed to take advantage of the pricing discounts available to those who purchase mass quantities of merchandise. Pursuant to an intercompany agreement with Mail Order, Dotcom, Retail, and Marketing, and in consideration for a fee, Wholesale determines the manufacturers and vendors of the merchandise and negotiates with them to set the price of the merchandise. Wholesale stores merchandise at its distribution facilities and it provides the merchandise on an as-needed basis to Retail and Marketing and to customers of Mail Order and Dotcom.

5. Description of Wholesale II's Business Operations.

Wholesale II manufactures and sells products to Wholesale, which in turn sells the products to Mail Order, Dotcom, Retail and Marketing. Wholesale II is a limited liability company owned by Wholesale.

6. Description of Developer's Business Operations.

Developer was formed for the purpose of engaging in real estate development activities.

It is headquartered in State X and has directly or indirectly engaged in development projects in several states. If Retail proceeds with the development of the Alabama Retail Center, Developer may purchase, develop, sell and/or lease real estate near the site of the Alabama Retail Center for commercial purposes. Developer may negotiate with the developer that will sell real property subject to certain covenants. If an agreement is made between Developer and the developer, Developer may receive commissions for bringing buyers to the developer. Developer has no intercompany relationship or transactions with any other Subsidiary.

At present, Developer has no physical facilities, retail outlets, employees or independent contractors in Alabama. Developer does not hold trade shows, store inventory, hold merchandise or lease or maintain any other property, real or personal, within Alabama. Developer does not have bank accounts in Alabama or employ persons within Alabama to collect overdue accounts. Developer does not hold an Alabama sales tax license or have a Certificate of Authority to transact business in Alabama.

7. Description of Travel's Business Operations.

Travel provides consultation and research on vacations and also makes bookings with airlines, hotels, and other providers of services and accommodations. It publishes catalogs promoting such vacations. Travel also operates a full-service travel agency for leisure and business travelers. Travel maintains its headquarters in State X. It advertises on the Site and in the Catalogs, in consideration for fees paid to Dotcom and Mail Order, respectively, and pursuant to intercompany agreements.

Travel does not have physical facilities, employees or independent contractors in Alabama. Travel does not hold trade shows, store inventory, hold merchandise or lease or maintain any other property, real or personal, within Alabama. Travel does not have bank accounts in Alabama or employ persons within Alabama to collect overdue accounts. Travel does not hold an Alabama sales tax license or have a Certificate of Authority to transact business in Alabama.

Travel also owns 100% of the membership interests in Properties, LLC ("Properties"). This entity provides a recreational multiple listing service for persons desiring to purchase or lease property. Licensed real estate brokers with whom Properties has a relationship locate suitable real estate. Properties then receives a commission on each sale or lease. At present, Properties offers real estate located in several states. Properties plans to expand its services to other states, including possibly Alabama.

8. Common Characteristics/Indicia of Separate Ownership.

Parent and all the Subsidiaries except Wholesale II, Mail Order II, and Mail Order III are headquartered in the hometown of its founders, which has a population of approximately 6,500, and is located some distance from any major metropolitan area. There are some commonalities between the entities. For example, the entities have some common officers and directors. Another example is that a building owned by Parent houses the headquarters of all of the State X-based Subsidiaries. Each of these Subsidiaries pays rent to Parent for the space occupied by it.

Mail Order, Dotcom, Retail and Marketing each sells similar products (hereinafter collectively referred to as "Products"), although each entity sells some Products that are particularly suited to its method and mode of operation and that are not sold by the other entities.

Each of Mail Order, Dotcom and Retail participate in the "VISA Program" (the "Program"). The Program awards points to individuals who have been issued a co-branded VISA® card (the "Card") and who use the Card to purchase merchandise. The points can be used to purchase merchandise and services sold by Mail Order, Dotcom, and Retail.

A number of intercompany agreements exist between Parent and the Subsidiaries and between the Subsidiaries. In addition to those previously described, Mail Order, Dotcom, Retail and Marketing have entered into intercompany agreements with Wholesale with respect to their respective return policies. All sales returns which are mailed in by customers are mailed to Wholesale's return center in State X. Wholesale pays the customer the full price of any returned item. The entity that originally sold the item reimburses Wholesale for this amount. Wholesale then pays that entity for the item at cost, places the item back in inventory and re-sells it to Mail Order, Dotcom, Retail or Marketing.

Retail maintains a customer-friendly service policy that requires each Retail Center to purchase, at full retail value, any product that a customer desires to "return", including products originally purchased from Retail's competitors, if the product is one that is sold in the Retail Centers. Retail implemented this policy in order to build goodwill among its current and potential customers, based on the belief that visitors who "return" products not originally purchased from Retail will be pleased with the customer service and will purchase more Products from Retail. This policy means that Retail purchases merchandise sold by Mail Order, Dotcom and Marketing, as well as merchandise sold by competitors.

In addition, customers who patronize the Retail Centers may be asked if they would like to receive additional information about products similar to those sold by Retail. If the customer responds in the affirmative, a Retail employee will accept the customer's e-mail and home address. The lists of e-mail and home addresses are added to Retail's customer database for future Retail mailings. In addition, the lists of e-mail and home addresses may be sold by Retail to third parties, including Mail Order or Dotcom. If the lists of addresses are sold to third parties, such sales will be made pursuant to agreements and negotiated at arms length and for fair market value consideration.

While the members of the Consolidated Group benefit from the efficiencies resulting from the above-described intercompany services and integrated functions, each remains a distinct enterprise which operates separate and apart from the others. Moreover, each entity is held out to the public as a separate entity. For example, the Site now has a page that describes the separate operation and activities conducted by each of the members of the Consolidated Group. Further, each entity is solely responsible for the success of those operations under its control. Management of each entity is evaluated and compensated (for example, with profit-based bonuses) based upon how well that entity performs. Each company is adequately capitalized and pays for its own capital expenditures and operating expenses out of its capital and from the profits of its business. Each company hires its own employees.

REQUESTED DETERMINATIONS

The Consolidated Group acknowledges that the proposed ownership of property by Retail and Developer, and the employment of in-state residents by Retail, will create nexus for Retail and Developer for tax purposes with Alabama. Parent and the Subsidiaries request the following determinations:

(1) Neither Parent nor any of the Subsidiaries currently has nexus with Alabama for sales or use tax, or corporation income tax, or business privilege tax purposes.

(2) The proposed future activities in Alabama by Retail and Developer will not create nexus for Parent or the other Subsidiaries in Alabama for sales or use tax, or corporation income tax, or business privilege tax purposes.

(3) Parent's licensing of intellectual property to Subsidiaries, which will use it in Alabama, will not create nexus for Parent for corporation income tax, or business privilege tax purposes.

(4) The Department will not reverse, challenge or take actions adverse to any such determination unless it is required to do so as a result of (a) an amendment to the United States Constitution, (b) a decision by the United States Supreme Court or (c) the enactment of a federal law or laws of general applicability.

LAW AND ANALYSIS

Some of the requested rulings in this request for a revenue ruling concern the application of laws to business practices in which the taxpayer has been engaging for years. Pursuant to Rule 810-14-1.06(3)(f), these are not the types of questions for which the taxpayer is entitled to seek guidance through the issuance of a revenue ruling. The Rule provides that a request must include the following:

> f) A statement that the request is for a proposed transaction or event, and that no taxes have accrued or will accrue prior to the issuance of the ruling with respect to the transactions, events, or facts contained in the request. If the transaction or event subject to the ruling request is in the nature of a series of transactions or events whereby some of the transactions or events have occurred in the past and some of the transactions or events are prospective in nature, a ruling will not be issued.

Therefore, the current activities and tax status of the members of the Consolidated Group will be discussed only as necessary to render an informed decision regarding the impact on their tax status of the proposed activities of Retail and Developer. The tax status of only those entities having an intercompany agreement with Retail and Developer will be addressed.

ANALYSIS OF SALES AND USE TAX LAW

1. Applicability of the Sales And Use Tax to the Current Activities in Alabama of the Sales Group and Retail.

The Alabama use tax is complementary to the Alabama sales tax and is levied on tangible personal property purchased at retail outside of Alabama that is subsequently used, stored, or consumed in Alabama. Ex parte Fleming Foods of Alabama, Inc., 648 So.2d 577 (Ala. 1994), cert. denied, 115 S.Ct. 1690 (1995). Use tax is levied against the individual or business that uses, stores, or consumes the property in Alabama. However, because of the impracticability of collecting use tax from the individual user, the out-of-state seller is required to collect and remit the tax to the Department. Code of Ala. 1975, §40-23-67.

Section 40-23-68(b) lists various activities in Alabama that would subject an out-of-state retailer to Alabama use tax. The broad statutory language set forth in the statute would initially indicate that the activities conducted by the Sales Group amount to being "engaged in making retail sales for storage, use, or other consumption" in Alabama for use tax purposes. However, the statutory authority set forth in Sections 40-23-67, 40-23-68(b)(9), 40-23-4(a)(17) and 40-23-62(2) acknowledges that federal authority exists regarding the duty of entities to collect and remit sales and use tax. Section 40-23-68(b)(9) provides that use tax will not be applied to any transaction that Alabama is prohibited from taxing under the United States Constitution or laws of the United States of America.

Federal nexus jurisprudence requires an analysis of the Commerce Clause, which provides for Congressional regulation of interstate commerce. The Commerce Clause provides that "Congress shall have the power to regulate Commerce with foreign Nations, and among the several states, and with the Indian tribes." *U.S. Constitution*, Art. 1, Sec. 8, Cl. 3. The Commerce Clause has been interpreted as not only conferring power on the national government to regulate commerce but also as limiting the states' power to interfere with commerce. Under the "dormant" commerce clause principle, taxes that have been found to unduly burden interstate commerce have been declared unconstitutional.

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Supreme Court established a four-prong test for determining whether a state tax unconstitutionally burdens interstate commerce. The tests are:

1. Nexus - the tax must be applied to a taxpayer or an activity with substantial nexus.

2. Fair apportionment - the tax must be fairly apportioned.

3. Nondiscriminatory – the tax must not discriminate against interstate commerce. The Commerce Clause prohibits taxes that favor local or intrastate business over interstate business.

4. Fair relation to benefits – the tax must be fairly related to the services provided by the state. The services provided may include a stable market, police and fire

protection, a trained work force, mass transit, public roads, or more generally, the advantages of a civilized society.

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the United States Supreme Court reaffirmed its holding in *Nat'l Bellas* Hess, *Inc. v. Dept. of Revenue of Illinois*, 386 U.S. 753 *(*1967), that the Commerce Clause requires an activity to have a "substantial nexus" with a state before that state may tax the activity. Specifically addressing sales and use tax nexus, the Supreme Court also held that a direct-mail business does not have a "substantial nexus" with the state for sales and use tax collection purposes unless it has a physical presence in the state. The Supreme Court stated that *Bellas Hess* "created a safe harbor for vendors `whose only connection with customers in the [taxing] state is by common carrier or the United States mail.' Under *Bellas Hess* such vendors are free from state-imposed duties to collect sales and use taxes." *Quill*, 504 U.S. at 315. Thus, physical presence is the bright-line test under the Commerce Clause for sales and use tax nexus.

The debate since *Quill* has generally revolved around three questions:

1. How much physical presence is sufficient to create "substantial nexus"?

2. Can nexus be attributed to the seller through the physical presence of the seller's agent or affiliate?

3. Does the *Quill* physical presence test apply beyond the sales and use tax arena?

The United States Supreme Court has stated that physical presence must be more than the "slightest presence" to rise to a "standard of constitutional nexus." *National Geographic Soc'y v. California Bd. Of Equalization,* 430 U.S. 551, 556 (1977). For example, in *Quill* the Court held that Quill's ownership of some floppy disks and the licensing of the accompanying software in North Dakota did not create sales and use tax nexus in the state. The disks, while owned by Quill, were software used by its customers to place orders and check current inventories and prices.

Even prior to the decision in *Quill*, the Alabama Supreme Court held that a foreign business must have a "business nexus" with Alabama before use tax can be imposed. *State v. Lane Bryant, Inc.*, 171 So. 2d 91 (Ala. 1965). *In Lane Bryant*, the Alabama Supreme Court held that to impose use taxes on an out-of-state mail order company whose only connection with the State was the mailing of catalogs to residents of the State would violate the Due Process Clause and Commerce Clause. The Court of Civil Appeals of Alabama incorporated this holding in *Yelverton's, Inc. v. Jefferson County*, 742 So. 2d 1216, 1220 (Ala. 1997), finding that "an out-of-state seller is required to collect use taxes only if the seller has sufficient nexus with the State of Alabama."

None of the Sales Group or Retail currently has a physical presence or has sufficient contact with the State of Alabama to satisfy the substantial nexus requirement of federal law. Based on the foregoing, none of the Sales Group or Retail is presently required to collect and remit sales or use tax on sales to Alabama residents.

2. The Effect on the Sales Group of Retail's Proposed Activities in Alabama.

Section 40-23-190, Code of Alabama 1975, purports to statutorily create nexus for sales and use tax purposes if an "out-of-state vendor and an in-state business maintaining one or more locations within the State are related parties" and one of the following conditions is met: (1) the out-of-state business and the in-state business use an identical or substantially similar name, tradename, trademark, or goodwill, to develop, promote or maintain sales; (2) the out-of-state business and the in-state business pay for each other's services in whole or in part contingent upon the volume or value of sales; (3) the out-of-state business and the in-state business share a common business plan or substantially coordinate their business plans; or (4) the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market. Section 40-23-190 includes in the definition of "related parties" those satisfying the attribution rules of Section 318 of the Internal Revenue Code. The members of the Consolidated Group are related parties under §190.

Three of the conditions that create nexus under §40-23-190 apply to Retail and the members of the Sales Group. First, each entity utilizes a common trademark. The Catalog published by Mail Order has been around for many years, and it is one of the most popular catalogs published today. Consequently, the "Parent" trademark is very famous. Its use by Retail increases the public's awareness of the activities conducted by the members of the Sales Group and Wholesale, which would develop, promote, or maintain sales for the members of the Sales Group or Wholesale. The third condition of Section 40-23-190 concerning common business plans is also satisfied. The companies share common facilities, officers and directors. While to some extent each entity is operated separately and each entity is responsible for creating and implementing its own business plan, Parent appears to exert considerable control over the activities of the Subsidiaries. Furthermore, the intercompany agreements show that they substantially coordinate their business plans. The last condition of Section 40-23-190 is that the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting, or maintaining the in-state market. Retail provides services for the Sales Group to assist them in developing, promoting, or maintaining an in-state market. Further, the fact that any services that are provided are made pursuant to agreements for fair market consideration is not significant under this provision of the statute. Based on the foregoing, it is the Department's position that the statutory conditions set forth in Section 40-23-190 are satisfied, and therefore nexus would be created for the members of the Sales Group due to the presence and the activities of the Alabama Retail Center.

The intercompany agreements and transactions described above between Retail and members of the Sales Group might not establish a principal/agent relationship under Alabama law for other purposes because there is purportedly no right of control or actual control. However, an agency relationship is not necessary under §40-23-190, federal law, or Alabama case law to establish nexus for sales and use tax purposes.

The United States Supreme Court has held that independent contractors can create nexus for an out-of-state retailer. "The test," according to the Court, "is simply the nature and extent of the activities" in the state. Where there is "continuous local solicitation" and the independent contractors are performing the same role and functions as sales employees by establishing and

maintaining a market in the state for the remote seller, the out-of-state seller has nexus with the state. See *Scripto, Inc. v. Carson*, 362 U.S. 207, 208 (1960). In *Scripto*, the Court held that in-state activities on Scripto's behalf by ten part-time independent contractors created nexus, even though these independent contractors worked for competing companies. The Court held that the distinction between employees and independent contractors was of no constitutional significance. The important fact is that the in-state activity is effective in creating and maintaining the in-state market. *Scripto*, 362 U.S. at 211-212. Similarly, in *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987), the activities of one independent contractor residing in the taxing State were sufficient to create a taxable presence in the State on behalf of the company to impose Washington's Business and Occupations tax. In *Tyler Pipe*, the Court held that the critical test was "whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Tyler Pipe*, 483 U.S. at 250. The Court found this standard was satisfied because "Tyler's sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interests." *Id.* at 251.

Alabama has followed *Scripto* in holding that nexus of a foreign corporation with Alabama is constitutionally sufficient to support the liability of the corporation to collect use taxes on sales to customers in Alabama solicited for it by its salesmen operating within Alabama regardless of the designation of such salesmen as agents or independent contractors. In *Ex parte Newbern*, 239 So.2d 792 (Ala. 1970), in referring to *Scripto*, the Alabama Supreme Court stated:

> We do not see that the court was required to employ common law labels in articulating constitutional standards in this area.
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> We do not mean to say that the intimacy of the relationship between the out-of-state seller and persons whose activity within Alabama is sought to be imputed to him is entirely irrelevant; on the contrary, it may have some bearing on the sufficiency of the nexus. We merely say, as *Scripto* says, that the out-of-state seller Nationwide's relationship with Alabama is close enough, constitutionally for use tax purposes, when it receives orders, resulting in a substantial flow of goods, from Alabama customers solicited for it by its salesmen operating within Alabama.

The *Newbern* court also adopted language from *Topps Manufacturing Corporation v. State*, 212 Md. 23, 128 A.2d 595 (1957):

> We think that activities carried on in behalf of the foreign corporation by agents who are independent contractors, in connection with the matters for which they are agents, are as much in behalf of the corporation as similar activities carried on by agents who are servants, and we see no significant distinction in the two situations. The test is the nature and extent of the activities.

Newbern foretells that the Alabama Supreme Court would in all likelihood uphold the constitutionality of §40-23-190. Furthermore, Retail's activities on behalf of the Sales Group would create nexus for them in Alabama under *Scripto* and *Newbern* even in the absence of §40-23-190:

(1) Retail acts on behalf of these entities as a representative in the conduct of their business. Retail performs some of the same roles and functions as sales employees of those entities. That the intercompany activities are all undertaken for sufficient consideration and pursuant to intercompany agreements for fair market value and that they are negotiated at arms length is not determinative. Retail undertakes the activities not only for its own benefit, but also for the benefit of the Sales Group.

(2) In purchasing Catalogs, Retail's motivation may be to provide a benefit to its customers (i.e., an educational tool/sales guide) which in turn benefits Retail because these "educated customers" then buy more Products from the Retail Centers. However, these customers also place catalog orders that benefit Mail Order.

(3) In accepting Gift Certificates sold by Mail Order, Dotcom and Marketing, Retail benefits by being reimbursed in full from the entity that sold the Gift Certificate (thus, the profit from the sale belongs to Retail), and it also is afforded the opportunity to sell additional Products to the owner of the Gift Certificate. This activity by Retail also benefits Mail Order, Dotcom, and Marketing, however, by facilitating their customers' use of their Gift Certificates, which increases their ability to sell the Gift Certificates.

(4) In purchasing merchandise that is originally sold by the Sales Group, Retail is increasing the goodwill felt by not only its customers, but also the customers of the Sales Group. Facilitating the ease with which customers of the Sales Group can return an item for a refund obviously inures to the benefit of Mail Order, Dotcom, and Marketing.

(5) In collecting and selling lists of customers' addresses to Mail Order, Dotcom, and Marketing, Retail again benefits them by enabling them to focus their advertising efforts on likely customers.

3. The Effect on the Sales Group of Developer's Activities in Alabama.

The activities that Developer may possibly undertake in Alabama produce no basis for attributing nexus for sales and use tax purposes to members of the Sales Group. It engages in no intercompany transactions other than with the Parent.

ANALYSIS OF CORPORATION INCOME AND BUSINESS PRIVILEGE TAX LAWS

1. Applicability of Corporation Income Tax to the Current Activities in Alabama of the Sales Group and Wholesale.

With respect to corporation income tax, Section 40-18-2 levies a tax on:

(2) Every corporation domiciled in Alabama or licensed or qualified to

transact business in Alabama;

(3) Every corporation doing business in Alabama or deriving income from sources within Alabama, including income from property located in Alabama;
. . .

The Sales Group and Wholesale are subject to the corporation income tax only if they are "doing business in Alabama" or "deriving income from sources within Alabama." However, there is no statutory definition of the terms "doing business in Alabama" or "deriving income from sources within Alabama." Alabama courts have found that "[a] foreign corporation is doing business in Alabama if it is conducting some primary business activities or functions in Alabama." *Dial Bank v. State of Alabama*, 1998 WL 34279691, at page 5, citing *State v. Anniston Rolling Mills*, 27 So. 921 (Ala. 1900). Moreover, it has been held that "[a] corporation engaged in an activity that is 'merely incidental' to its primary business activity is not doing business in Alabama for franchise tax purposes." *Dial Bank*, citing *Omega Minerals, Inc. v. State of Alabama*, 288 So. 2d 145 (Ala. 1973). The Sales Group, Wholesale and Travel are currently conducting their primary business activities in Alabama. They are therefore "doing business in Alabama".

In addition to satisfying the Commerce Clause analysis described above, to establish nexus for corporation income tax purposes, federal law adds another hurdle in the form of the Interstate Commerce Tax Act, Public Law (P.L.) 86-272, codified at 15 U.S.C. §381 et seq. P.L. 86-272 provides that "[n]o state ... shall have the power to impose [an] income tax ... if the only business activities within such state [are] the solicitation of orders ... for sales of tangible personal property, which ... are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from outside the State..."

In *Wis. Dept. of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214, 112 S.Ct. 2447 (1992), the Supreme Court stated that the term "solicitation of orders" in the Interstate Commerce Tax Act cannot be interpreted narrowly to cover only the actual request for purchases or actions absolutely essential to making those requests. On the other hand, the Court also stated that the phrase should not be interpreted broadly to include all activities that are routinely, or even closely, associated with the solicitation, or that are customarily performed by salesmen. The Court also held that there is a *de minimis* exception to the in-state business activities that forfeit Interstate Commerce Tax Act immunity from state income taxation. The Court stated that the out-of-state manufacturers' in-state recruitment, training, and evaluation of sales representatives and its use of Wisconsin hotels and homes for sales related meetings were ancillary to requesting purchases for purposes of the Act. However, it held that the replacement of stale gum by sales representatives, the supplying of gum through "agency stock checks" and the storage of gum were not ancillary to requesting orders for purposes of the Act. Nor were these latter acts *de minimis*. The Court therefore held that Wrigley's activities in Wisconsin fell outside the protection of the Act.

The current activities of the members of the Sales Group constitute the mere solicitation of sales within the meaning of P.L. 86-272. Consequently, the members of the Sales Group do not have nexus for income tax purposes with the State of Alabama at the present time.

Likewise, Wholesale engages in an activity that is ancillary to the solicitation of orders, i.e., it fills the orders by shipment or delivery from a point outside the State, which is a part of the process specifically addressed in P.L. 86-272. Wholesale also engages in an activity that is not entirely ancillary to solicitation, i.e., it accepts returned merchandise and issues refunds on behalf of the Sales Group. See *Wrigley, supra*, at 2457. Wholesale's action in this regard may be viewed as *de minimis* insofar as it is attributed to the Sales Group, so that it will not cause the Sales Group to have nexus with Alabama for income tax purposes. Wholesale itself, however, is engaging in a business other than the solicitation of orders in Alabama, and consequently, it has nexus with Alabama for income tax purposes.

2. Applicability of the Business Privilege Tax to the Current Activities in Alabama of the Sales Group and Wholesale.

Alabama has a business privilege tax for corporations. Section 40-14A-22(a) provides that: "[t]here is hereby levied an annual privilege tax on every corporation, limited liability entity, and disregarded entity doing business in Alabama, or organized, incorporated, qualified, or registered under the laws of Alabama ... The amount of the tax due shall be determined by multiplying the taxpayer's net worth in Alabama by the rate determined in subsection (b)."

In *Quill supra*, the Court held that constitutionally sufficient nexus turns not on the level of in-state economic activity, but on whether a taxpayer is physically present in the State. The Court expressly limited its ruling to the sales tax arena, however. It also expressly overruled its earlier cases "to the extent that they have indicated that the due process clause requires physical presence in a state for the imposition of a duty to collect a use tax". In effect, the Court applied the minimum contacts test found in *International Shoe Co. v. Washington*, 326 U.S. 310 1945, which held that a defendant must have "minimum contacts" with the forum such that assertion of jurisdiction "does not offend traditional notions of fair play and substantial justice." *Id*. at 316. Thus, *Quill* held that the requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing state. The Court in *Quill* differentiated between Commerce Clause nexus and Due Process Clause nexus, a distinction to which it had previously alluded. See *McLeod v. J. E. Dilworth Co.*, 322 U.S. 349 (1944); and *Trionova Corp v. Michigan Dept. of Treasury*, 111 S.Ct. 818 (1991). Due process concerns itself with "notice" and "fair warning," while the Commerce Clause concerns itself with burdens on interstate commerce. Since *Quill*, some state courts have ruled that physical presence is required for business activity taxes, such as income taxes and franchise taxes, while others have not.

In *Lanzi v. Alabama Department of Revenue*, Docket No. INC. 02-721, the Alabama Department of Revenue's Administrative Law Division repudiated its earlier holding that a *Quill* physical presence test also applies to Alabama's income and franchise taxes. The ALD quoted the *Quill* Court that "We have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes" and "in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement," *Quill*, 112 S.Ct. at 1916. The ALD asserted that arguably, the Supreme Court's pre-*Quill* cases would apply so that some form of economic activity or presence in the taxing state would be sufficient as long as the taxpayer has minimum contacts with the state and interstate commerce is not unduly burdened.

After citing *Shaffer v. Carter*, 40 S.Ct. 221 (1920), for the proposition that a State has jurisdiction to tax a nonresident on income derived from property or business transacted by the nonresident in the State, the ALD refused to attribute the nexus of the limited partnership which conducted business in Alabama to the limited partner. The ALD based his holding on the entity theory of partnerships, under which a partnership is an entity distinct from its partners. Essentially, the ALD refused to hold the partnership to be the alter ego of the nonresident partner.

In Alabama, the separate identities of affiliate corporations are generally recognized where the business of the dominant corporation justifies the creation of affiliate corporations to perform separate functions, the affiliates have a separate group of employees and managers, and separate facilities and arrangements, and there are no confusing or fraudulent relations to mislead the public. *Ledlow v. Goodyear Tire & Rubber Co. of Alabama*, 190 So.78 (Ala 1939). The *Ledlow* Court also recognized that a corporation may be engaged in its business transactions through the agency of a subsidiary corporation as through any other agency. Therefore, it appears that whether affiliated corporations may be viewed as the alter egos of one another or as agents of one another under state law corporate and agency principles is determined by the facts of the particular situation. As previously stated, however, state law principles of agency are not strictly applied where the issue is nexus for tax purposes. *Scripto*; *Newbern, supra*.

Among the pre-*Quill* cases alluded to by the ALD in addition to *Shaffer v. Carter*, is *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), in which the Court upheld the constitutionality of a Wisconsin tax on International Harvester shareholders measured by the Wisconsin portion of dividend distributions. The Court stated that "A state may tax such part of the income of nonresidents as is fairly attributable either to property located in the state or to events or transactions which are occurring there, are subject to state regulation, and which are within the protection of the state and entitled to numerous other benefits which it confers on them.

Moreover, in his analysis of International Harvester, Professor Hellerstein concludes:

> [T]here is no denying the fact that the Court's opinion in International Harvester lends powerful support to those who argue that a state has constitutional power to impose a tax on a nonresident based solely on the fact that the source of the nonresident's income is derived from activities conducted in the state, regardless of whether the nonresident has any physical presence in the state.

Jerome R. Hellerstein & Walter Hellerstein, 1 State Taxation (3d ed. 1998 & Supp. 2002).

In *New York ex rel. Whitney v. Graves*, 299 U.S.366 (1937), the Court held that New York could tax a nonresident on the gain from the sale of a membership in the New York Stock Exchange without violating the due process clause. There is a requirement of both the due process and commerce clauses that there be some definite link, some minimum connection between a state and the person, property, or transaction it seeks to tax. *Allied-Signal, Inc. v. Director, Division of Taxation*, 112 S.Ct. 2251.

It is unclear whether there presently exists any significant distinction between the due process and the commerce clause nexus requirements of the U.S. Constitution in areas other than sales tax. Until the courts articulate such a distinction, taxing authorities may assume that nexus for Commerce Clause purposes is met where the requirements for nexus under the Due Process Clause are met. Therefore, the State acquires nexus with the taxpayer or nexus with the transaction, activity, or property sought to be taxed if the taxpayer "purposely avails itself of the privilege of conducting activities within the forum state," *Worldwide Volkswagon Corp v. Woodson*, 100 S.Ct. 559, or the taxpayer has purposely directed its activities toward the state, *Burger King v. Rudzewicz*, 105 S.Ct. 2174 (1985). See also *Asahi Metal Industry Co. Limited v. Superior Court of Cal.*, 107 S.Ct. 1026 (1987). These cases support the proposition that the mere solicitation of business by a foreign corporation in a state provides a sufficient nexus for a state to tax a corporation for taxes other than sales tax. Further, any economic presence of the taxpayer in which the taxpayer attempts to avail itself of the in-state market would support a tax other than the sales or use tax. "Applying these due process principles, we have held that if a foreign taxpayer purposely avails itself of the benefits of an economic market in the foreign state, it may subject itself to the state's in personam jurisdiction even if it has no physical presence in the state". *Quill*, 112 S.Ct. at 1910.

Applying the above-stated standards leads to the conclusion that the Sales Group and Wholesale have nexus with Alabama for purposes of the business privilege tax.

3. The Effect on the Sales Group of Retail's Proposed Activities in Alabama.

As noted above, Retail purchases Catalogs for use in the Retail Centers, accepts Gift Certificates sold by Mail Order, Dotcom, and Marketing, purchases products originally sold by Mail Order, Dotcom and Marketing, and may sell lists of customers' addresses to Mail Order, Dotcom, and Marketing. It is contemplated that the Alabama Retail Center would undertake all of these activities.

The proposed activities by Retail conducted on behalf of the Sales Group will propel these entities outside the safe harbor created by P.L. 86-272 so as to subject them to the State's income tax. These activities are not *de minimis*. Moreover, they are not ancillary to the solicitation of orders because they serve an independent function apart from their connection to the solicitation of orders.

4. Applicability of Corporation Income and Business Privilege Taxes to Parent's Licensing of Intellectual Property to the Subsidiaries.

The taxation of licensing of intellectual property is only applicable to those corporations that are subject to tax in Alabama (i.e., are doing business in Alabama or are deriving income from sources within Alabama). As discussed above, Parent has licensed certain of its trademarks to the Subsidiaries. Retail and Ventures will use the licensed trademarks in connection with their respective business operations in Alabama. The members of the Sales Group, Wholesale and Adventures also use the licensed trademarks in connection with their marketing and sales activities.

Some courts have taken the position that the licensing of an intangible asset, and the

subsequent presence of that intangible asset in a state in which the licensor has no physical presence, can be deemed to create income tax nexus for the licensor. See *Geoffrey, Inc. v. South Carolina Tax Commission, 437* S.E.2d *13 (S.C. 1993).* See also *Borden Chemicals & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73 (2000); *Gore Enterprises Holding Co. v. Director of Revenue*, 99-2856 R.I. Other courts have declined to follow *Geoffrey*, instead taking the position that the licensor must still have a physical presence in the taxing state before it can be subject to income tax nexus. See, e.g., *ACME Royalty Co. v. Director of Revenue*, 96 S.W.3d 72 (Mo. 2002) (rejecting the contention of the Missouri Department of Revenue that no physical presence of an intellectual property licensor is needed when the related-party licensee has nexus in Missouri); Rylander *v. Bandag Licensing Corp*., 18 S.W.3d 296 (Tex. Ct. App. 3d Dist., 2000); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

In *Boswell v. Paramount Television Sales*, 282 So.2d 892 (Ala. 1973), a remote seller licensed films to local Alabama television stations for 48 hours, after which the films were promptly returned to the remote licensor by mail. The court held that the in-state presence of the films was sufficient to establish nexus for rental tax purposes:

> … Paramount has property in Alabama. … Paramount is present by the ownership of film, which is rented and used in Alabama to make money, and then returned to Paramount.

Thus, *Paramount* holds that ownership of tangible property in Alabama can establish presence in Alabama so as to subject the owner of the property to taxation in this state. In Alabama, the rental tax, unlike the sales and use tax, is levied directly on the lessor, rather than on the consumer/lessee. *Paramount*'s reasoning is therefore applicable to the income tax and the business privilege tax.

In *Paramount*, the taxpayer contended that the essence of the transaction was an intangible right to publish and that the transfer of this right to publish or broadcast, even though accompanied by delivery of tangible personal property, i.e. the films, was not a rental of tangible personal property. The court disagreed, finding that it was the films or finished product that were leased, not the intangible right to broadcast, and that the license to publish without the physical transfer of the films would be valueless.

The licensing of trademarks by Parent is similar to the rental of the films in *Paramount*. In both cases intangible property, i.e. the trademarks and the programming, constitute intangible property. However, the intangible property can only be utilized through its embodiment on a tangible medium. In *Paramount*, the medium was the film. In the case of the Parent, the tangible property is the printed or otherwise displayed trademark of the Parent. Whether the trademark is viewed as intangible or its physical display is viewed as tangible property, the fact remains that it is actually utilized for display in a physical form.

There is no compelling reason to distinguish between the ownership of tangible property and the ownership in the state of intangible property for purposes of establishing presence or nexus. Both *Paramount* and the federal cases cited previously indicate that Parent has nexus with Alabama. Retail and Developer's proposed activities in Alabama will increase Parent's

nexus with Alabama, which is already sufficient to support the imposition of corporation income taxes and business privilege taxes by Alabama.

EFFECT OF REVENUE RULING

The Department's authority to revoke or modify Revenue Rulings is governed by §40-2A-5(c), Code of Alabama 1975, which provides that Revenue Rulings may be revoked or modified by the Commissioner at any time, but that the revocation or modification shall not be effective retroactively unless certain conditions are met. The Department declines to surrender its statutory right to revoke or modify this Revenue Ruling for any proper reason, including any future decision to apply its powers contained in §40-2A-17, Code of Alabama 1975, to the activities of the Consolidated Group.

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G. THOMAS SURTEES
Commissioner
Alabama Department of Revenue