

March 30, 2017

In Re: McKesson Corporation

Docket No:36BPMERZZ8363

In Re: Sterling Medical Services, LLC.

Docket No:36BPMERZZ8021

Statement of Record-McKesson Corporation

1. McKesson Corporation [hereafter McKesson or Petitioner(s)] filed a Petition for Appeal with the Tax Review Board on October 25, 2010 requesting review of a City of Philadelphia audit assessment for BIRT for the years 2003 through 2008 and the 2009 mandatory estimated payment. A supplement to this petition was filed on February 7, 2012.
2. An administrative review hearing was scheduled for September 8, 2011 and continued at the request of the City of Philadelphia.
3. An administrative review hearing was scheduled for August 9, 2012 and converted to status hearing at the request of the parties.
4. A status hearing was scheduled for October 9, 2012.
5. An administrative review hearing was scheduled for April 16, 2013 and continued at the request of the City of Philadelphia for the completion of a re-audit by the Philadelphia Department of Revenue.
6. An administrative review hearing was scheduled for November 19, 2013 and continued at that time.
7. An administrative review hearing was scheduled for April 23, 2014. This hearing was continued at the request of Petitioner with a request for a consolidated hearing with Sterling Medical Services, LLC Corporation due to the identical nature of the legal issues to be presented. This request for consolidation was consented to by the City of Philadelphia and was approved by the TRB.
8. Additional hearing dates were scheduled for June 3, 2014, August 7, 2014, November 6, 2014, January 8, 2015, April 23, 2015, June 25, 2015, September 9, 2015, November 5, 2015, February 18, 2015, June 6, 2016 for status updates as the parties continued to complete a City audit and share documents and information needed to prepare for this appeal.
9. The Tax Review Board held an administrative review hearing, beginning June 16, 2015, focused on Sterling, which continued on June 21 and June 23, 2016 to present evidence related to McKesson Corporation. A briefing schedule was agreed upon followed by legal arguments before the Board on November 3, 2016. The Board then took the matter under advisement for consideration.
10. The TRB announced its decision to deny McKesson's petition on December 15, 2016
11. McKesson filed an appeal to the Court of Common Pleas.

Statement of Record – Sterling Medical Services, LLC:

1. Sterling Medical Services, LLC. [hereafter Sterling or Petitioner(s)] filed a Petition for Appeal with the Tax Review Board (TRB) on October 22, 2013 requesting review of a City of Philadelphia assessment for Business Income and Receipts Tax (BIRT) for the tax year 2010 and the tax year 2011 estimated payment. An amendment to the Petition for Appeal was filed on December 14, 2015 to add tax years 2009 and 2011-2014 to the request for review by the TRB.
2. An administrative review hearing was scheduled for April 23, 2014. This hearing was continued at the request of Petitioner with a request for a consolidated hearing with McKesson Corporation due to the identical nature of the legal issues to be presented. This request for consolidation was consented to by the City of Philadelphia and was approved by the TRB.
3. Additional hearing dates were scheduled for June 3, 2014, August 7, 2014, November 6, 2014, January 8, 2015, April 23, 2015, June 25, 2015, September 9, 2015, November 5, 2015, February 18, 2015, June 6, 2016 for status updates as the parties continued to complete a City audit and share documents and information needed to prepare for this appeal.
4. The Tax Review Board held an administrative review hearing, beginning June 16, 2015, focused on Sterling, which continued on June 21 and June 23, 2016 to present evidence related to McKesson Corporation. A briefing schedule was agreed upon followed by legal arguments before the Board on November 3, 2016. The Board then took the matter under advisement for consideration.
5. The TRB announced its decision to deny Sterling's petition on December 15, 2016
6. Sterling filed an appeal to the Court of Common Pleas.

Findings of Fact:

All facts below are relevant to Petitioners' activities during the tax years under appeal.

McKesson Corporation

- 1) McKesson Corporation (Petitioner or McKesson) filed an appeal for a BIRT assessment for the years 2003-2008. Principal amount due was ~~XXXXXXXXXX~~, with interest of ~~XXXXXXXXXX~~ and penalty of ~~XXXXXXXXXX~~ as of the TRB hearing date, for a total due of ~~XXXXXXXXXX~~.
- 2) The Partial Stipulations of Facts executed by the parties on June 21, 2016 and September 1, 2016 are hereby incorporated by reference.
- 3) The assessment under appeal is for the gross receipts portion of the BIRT.
- 4) Any assessment on net income under the BIRT was withdrawn by the City at the June 21, 2016 hearing before the TRB.
- 5) Petitioner is a Delaware corporation with its primary place of business in San Francisco, CA.
- 6) Petitioner is a distributor at the wholesale level of medicines and medical supplies from 30 distribution sites throughout the U.S. McKesson does not have a distribution center in Philadelphia. Petitioner sells over the counter healthcare products, pharmaceuticals, and certain medical equipment.
- 7) Petitioner's customers are healthcare providers such as physicians and pharmacists.
- 8) McKesson had approximately 100 customers in Philadelphia during the years under appeal.

- 9) Products for customers in Philadelphia are shipped by common carrier primarily from distribution centers located in Delran, NJ and New Castle, Delaware.
- 10) McKesson does not have an office or other type of physical location in Philadelphia.
- 11) McKesson supplies its customers with handheld electronic devices called Texlons. These devices are used by its customers to order products and manage their product inventory.
- 12) Gross annual receipts for Philadelphia sales ranged from [REDACTED] to [REDACTED].
- 13) Customers range from individual physicians to independent pharmacies to major institutions and hospitals.
- 14) Individual sales representatives are assigned a specific geographic area to work for the company. This assignment may be based on their residency, the number of customers in a particular region, or other business considerations.
- 15) During the audit period, Petitioner had 3-4 sales representatives servicing customers in Philadelphia.
- 16) The sales representatives assigned to Philadelphia would not be limited to Philadelphia in their work. Each would come into Philadelphia 1 to 2 times a week and be in other locations on other days.
- 17) When visiting a customer, a service representative is expected to ensure that the customer is receiving their order as placed, and that the mix of products is what they need, to offer suggestions, and handle other customer service issues.
- 18) Petitioner enters into a business relationship with a customer in several ways. For large national companies or large institutions, such as a hospital, Petitioner generally responds to a company Request for Proposal for the medical or pharmaceutical products sold by Petitioner. If a successful bidder, Petitioner enters into a contract with the corporation or institution. The RFP and contracting process generally occur from Petitioner's locations or offices outside of Philadelphia. Once a contract is executed, then a sales representative visits the customer in Philadelphia and services the account. This sales representative will also try to get the contract extended when it approaches its end date.
- 19) For smaller independent stores or pharmacies in Philadelphia, a sales representative will visit the store to attempt to enter into a business relationship to supply Petitioner's products.
- 20) Each individual store places its own order with Petitioner, even for national chains with one master or nation-wide contract.
- 21) Most orders are placed electronically through a handheld ordering device provided to each customer by Petitioner, called a Texlon. Petitioner charges a monthly fee for its use.
- 22) During the relevant tax years, there were approximately 69 Texlon devices being used by customers in Philadelphia.
- 23) Customers can also order via PC based internet site or using a paper order form.
- 24) The handheld device, called Texlon, remains the property of Petitioner, to be returned to Petitioner if the relationship ends or to be replaced by Petitioner if the device breaks or becomes obsolete.
- 25) The Texlon has several functions:
 - 1) McKesson product orders can be placed
 - 2) Inventory count can be maintained
 - 3) Reports can be generated for use by the customerThe device is specific to Petitioner's company and could not be used for any other purpose.
- 26) During the tax years in question, Petitioner filed BIRT returns with the City of Philadelphia. These returns listed Petitioner's gross receipts and distribution costs, including cost of goods sold in

Philadelphia. For all years, Petitioner listed its costs as being in excess of its sales receipts with a result of zero taxable gross receipts.

- 27) In its filed BIRT returns, Petitioner deducted costs for information technology services and costs of material and labor attributable to Philadelphia sales.
- 28) The bill under appeal came about as a result of an audit and a re-audit by the Philadelphia Department of Revenue. Costs to Petitioner were recomputed from the information supplied to the auditor by Petitioner resulting in a finding of gross receipts in excess of Petitioner's costs. Petitioner's reported gross receipts were accepted by the auditor.
- 29) At the TRB hearing, Max Foster, employed by Petitioner as a Senior Tax Director, testified that while he did not have any first hand knowledge as to how the BIRT returns filed each year by Petitioner, were prepared, a company selling its goods for less than the cost, as shown in Petitioner's filed returns, could not be explained and such a business would have a hard time staying in business very long.

Sterling Medical Services, LLC

- 1) The Partial Stipulation of Facts executed by the parties on June 16, 2016 is hereby incorporated by reference.
- 2) Sterling Medical Services (Petitioner or Sterling) is currently a subsidiary of the companion petitioner, McKesson Corporation, which acquired Sterling in 2014. However, the following facts were relevant for the assessment years under appeal.
- 3) Petitioner challenges the assessed BIRT on the gross receipts from sales in Philadelphia. The tax was assessed for years 2009-2014. Principal amount due was [REDACTED], with interest of [REDACTED] and penalty of [REDACTED], as of the TRB hearing, for a total due of [REDACTED].
- 4) Petitioner is a nationwide retailer of medical supplies.
- 5) Petitioner employs more than 30 sales representatives across the country.
- 6) During the tax years in question, Petitioner deployed 2 sales representatives to Philadelphia to solicit business for Petitioner and service accounts.
- 7) These sales representatives visited various health care facilities, including doctor's offices, rehabilitation facilities, nursing and managed care facilities, all known as referral sources, to convince health care providers in these facilities to recommend Petitioner's products to their patients.
- 8) Petitioner's actual customers are the patients who purchase Petitioner's products.
- 9) Sales orders can be placed directly by the patients or by the health care provider for their patients, the ultimate users of the products.
- 10) Orders can be placed with Petitioner by phone, fax or internet. When an order is received, the patient's health insurance information is obtained for billing by Petitioner, and products are shipped by common carrier, such as UPS. The patient is billed directly by Petitioner for any balance due after insurance payment. Products are shipped directly to the patient.
- 11) Petitioner does not have a warehouse or distribution center in Philadelphia. All products are shipped into Philadelphia from outside of the City.
- 12) Petitioner does not have any office or place of business in Philadelphia.
- 13) Orders are placed by patients directly to the company and accepted and approved by the company prior to shipping of the products.

- 14) Most product payments are from medical insurance providers directly to Petitioner. Patients are billed directly for insurance deductibles or copays where appropriate. Patients without insurance pay directly for the products they order.
- 15) Sales representatives in Philadelphia solicit referrals from health care providers to market and Petitioner's products to patients.
- 16) All products require a medical prescription.
- 17) When meeting with a health care provider, Petitioner's sales representatives may demonstrate or show the actual products and may leave samples with the provider. They may leave brochures at the office. The sales meeting purpose is to convince the health care provider and staff to recommend or prescribe Petitioner's products to their patients.
- 18) The City auditor testified that his assessment was made using the documents supplied by Petitioner. These documents provided a breakdown by year of the gross receipts earned by Petitioner from sales in Philadelphia. The auditor did not alter or challenge Petitioner's documents, other than through some non-material clerical errors on reports.
{see stipulated exhibits 6 & 8}
- 19) The auditor relied on Stipulated Exhibit 7 as an adequate description of Sterling representatives' activities in Philadelphia to conclude that only the gross receipts portion of the BIRT should be assessed.

Conclusions of Law:

1. Petitioners, McKesson Corporation and Sterling Medical Services, LLC, filed separate Tax Review Board (TRB) petitions, each presenting a challenge to the Philadelphia Department of Revenue assessment of Business Income and Receipts Tax (BIRT) on their individual gross receipts attributable to sales for medical supplies and equipment to customers in Philadelphia. By agreement and acknowledgement of the parties, the legal issues presented by these 2 entities are identical and the cases were consolidated for the TRB hearing and have been consolidated for purposes of this TRB Opinion.

The City of Philadelphia BIRT, formerly known as the Business Privilege Tax (BPT), was enacted by grant of authority from the Commonwealth of Pa. under the First Class City Business Tax Reform Act of 1984, 53 P.S. §16181 et seq. This Act authorized the City of Philadelphia to impose a tax upon persons engaged in business, with business defined as "(c)arrying on or exercising for gain or profit, within a city of the first class, any trade, business, including financial business as hereinafter defined, profession, vocation or commercial activity or making sales to persons within such city of the first class." 53 P.S. §16184.

The assessments in question are for BIRT imposed by The Philadelphia Code Chapter 19-2600 et seq. This tax has two parts, a tax on gross receipts and a tax on net profits.

The ordinance was amended in 1998 to include the "active presence" standard for imposition of the gross receipts portion of the BIRT.

Specifically, Petitioners challenge the BIRT assessment on gross receipts earned from their sales in Philadelphia pursuant to The Philadelphia Code Chapter 19-2603(3) which states as follows:

Any person having an *active presence* in the City is subject to the tax imposed by this Section. Any activity within the City by a person, through one or more employees, agents or independent contractors, that makes possible the creation, realization or continuance of contractual relationships between the person and customers located within the City, including but not limited to, the solicitation within the City by a person, through one or more employees, agents, or independent contractors, is sufficient to constitute *active presence* in the City. Physical presence (the maintenance of an office or property) in the City is not required to establish active presence in the City. (Emphasis added).

Petitioners argue that the active presence standard for imposition of the BIRT goes beyond the grant of authority to the City to impose this tax. Petitioners assert that a "solicitation plus" standard as stated in *Alan Wood Steel Company v. School District of Philadelphia*, 229 A.2d 881 (Pa. 1967) must be met by any taxpayer before they can be subject to tax for engaging in business within the taxing jurisdiction.

As stated by the Tax Review Board in its 1997 *Chrysler Corporation Opinion* (97-H), the BIRT, known then as the Business Privilege Tax (BPT), is a "privilege tax levied on the right and privilege to conduct business" in Philadelphia.

The TRB relies on *Clairol Inc. v. Commonwealth*, 513 Pa. 74, 518 A.2d 1165(1986) for its finding in the instant cases that the City of Philadelphia may assess the gross receipts portion of the BIRT based on an "active presence" standard. In *Clairol*, the Pennsylvania Supreme Court held that it was sufficient for the corporation to maintain an "active presence" in the taxing jurisdiction to be subject to a privilege tax. The "solicitation plus" standard set out in *Alan Wood Steel* is replaced by the "active presence" standard for the imposition of a privilege tax. The Court drew a clear distinction between the requirements for imposing an income tax, where the "solicitation plus" standard applies and a privilege tax where the "active presence" standard can be used.

A tax on net income is predicated on more than mere solicitation of business, it is a tax on the profit derived from doing business. When the Commonwealth seeks to tax the income of a corporation, something more than mere solicitation is required. The Court in *Clairol* found that "...since a franchise tax is not a tax on the income one receives, but on the privilege of doing business, or conducting the solicitation if you will, no more than the active presence of the corporation should be required, and the tax may be imposed regardless of the resulting profit or loss."

Each petitioner in this appeal meets the "active presence" standard and therefore is subject to the gross receipts portion of the BIRT.

Each of these corporations sells medical supplies. Their customer bases differ, with McKesson providing supplies to health care providers and Sterling selling its products directly to patients. Each maintained a small sales force which would regularly come into Philadelphia to solicit sales and service clients. McKesson also provided electronic equipment to facilitate sales and inventory management by its customers.

Petitioner, McKesson Corporation, was in contact with its Philadelphia customers in 2 ways. Individual sales representatives employed by the company made regular weekly visits to the approximately 100 customers in the city. Each of the 3 to 4 representatives were in the city 1-2 times per week, leading to approximately 600 to 800 sales calls in Philadelphia annually. Their job was to suggest products for purchase, help determine the correct product mix, make sure all orders were being received, and handle any issues or problems. In addition, most of the customers were provided with the Texlon electronic device, owned and serviced by Petitioner, through which a customer could place orders and manage personal inventory. Petitioner by its own tax returns acknowledged providing information technology services to its customers.

Petitioner, Sterling Medical Services, Inc., had its own 2 sales representatives in the City of Philadelphia meeting regularly through each year with health care providers to solicit referrals and sales of their products to the patients of these health care providers. These representatives demonstrated products, provided product samples and worked to convince health care professionals they visited to recommend Petitioner's products to their patient.

2. As to interest and penalties accrued against delinquent taxes, The Philadelphia Code §19-1705(2) provides:

Upon the filing of any petition for the waiver of interest and penalties accruing upon any unpaid money or claim collectible by the Department of Revenue, for or on behalf of the City or the School District of Philadelphia, the Tax Review Board may abate in whole or in part interest or penalties, or both, where in the opinion of the Board the petitioner acted in good faith, without negligence and no intent to defraud.

In this circumstance, both Petitioners are sophisticated corporations with professional advisors throughout the audit period.

McKesson filled returns each year showing, implausibly, cost of goods in excess of gross receipts to negate the gross receipts for tax purposes. Petitioner then reported zero tax due. The audit showed that this was not the case and that Petitioner had gross receipts far in excess of its deducted costs and expenses. Petitioner's Senior Tax Director, Max Foster, had no explanation for how these returns were prepared while acknowledging that it was unlikely any company could stay in business if in actuality it was charging its customers less than it was costing to provide the product.

It was only after the audit and the recalculated assessment bill that Petitioner raised any legal objection to the imposition of the BIRT on its receipts.

Sterling provided no information to explain its failure to file BIRT returns for all of the years it was actively engaged in business in Philadelphia. There was no claim that it was unaware of the tax and Philadelphia's imposition of the gross receipts portion of the tax on businesses with an active presence in the City or that Petitioner objected to the imposition of the tax based on the active presence standard. Sterling too failed to raise any legal objections to the City's imposition of the BIRT gross

receipts tax based on an active presence standard until the City's audit assessment was issued based on this standard.

Therefore, the decision of the Tax Review Board was to deny these Petitions for Appeal.

Concurred:

Nancy Kammerdeiner, Chair

George Mathew, CPA

Joseph Ferla

Gaetano Piccirilli, Esq.