The Tennessee Business Tax—An Outdated Law in a Modern Economy

The Tennessee Business Tax Act is ripe for a reevaluation and possibly a complete overhaul.

By: LOREN L. CHUMLEY

LOREN L. CHUMLEY is a principal in the Nashville office of KPMG LLP’s State and Local Tax practice. The information in this article is not intended to be “written advice concerning one or more federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP.

In the 11 years since I left state government, I have lost track of the number of questions on Tennessee taxes that I have fielded for multistate and multinational companies. When I need to run something by someone with authority, I am hard-pressed to find people more eager to help find an answer for a taxpayer than my former colleagues and friends at the Tennessee Department of Revenue. But I can say without question, the subject of the Tennessee business tax has brought more questions, consternation, and heartburn for clients—sometimes for what can be immaterial amounts of money—than any other area of Tennessee tax. As helpful as Department employees are on trying to find answers for the evolving tax policy, there is sometimes only so much one can do with a law that was originally intended to be a tax on local activity at the local level but has evolved into so much more.

In my work assisting clients with tax automation, I’ve run into the expression “Frankensystem”—where a company’s information technology group creates a “monster” system by “stitching” together various products and solutions.\(^1\) This analogy applies equally to certain attempts to fit nearly 50-year-old laws into
today's global economy. The current Tennessee Business Tax Act falls squarely within this analogy and is ripe for a reevaluation and possibly a complete overhaul.

**What is the Tennessee Business Tax?**

The Business Tax Act, Tenn. Code Ann. § 67-4-701, et seq., is a component of Tennessee's privilege taxes that is "in addition to all other privilege taxes." The tax is noted to be "in lieu of any or all ad valorem taxes on the inventories of merchandise held for sale or exchange by persons taxable under this part."²

At a high level, the business tax is imposed on every business making sales of either tangible personal property or services in Tennessee. The tax is measured by "gross sales" which are defined to mean "the sum total of all sales under this part as defined in this section, without any deduction whatsoever of any kind or character, except as provided in this part[.]"³ The tax rate applied to total sales depends on the type of property or services sold and whether the seller is considered a retailer or a wholesaler. Taxpayers are required to determine which of five major classifications they fall within, based on their dominant business activity, and different tax rates apply for each classification.⁴ This article focuses primarily on Classifications 1 through 3, which deal generally with the sales of tangible personal property and services.⁵

Like other gross receipts taxes, Tennessee's business tax comes up short when compared to various tax policy principles. The tax generally pyramids and penalizes non-vertically integrated businesses. For example, a business selling either equipment or raw materials to a manufacturer in Tennessee is required to report business tax on those sales. The manufacturer has an exemption from business tax if the sales of manufactured product are made at the location of the manufacturing facility, but if those sales are moved to another location, the exemption would not appear to apply. Business tax applies again when the wholesaler sells the finished product to a retailer and again when the retailer sells to a consumer in Tennessee.

In tax policy parlance, the tax is said to cascade or pyramid by being levied at multiple stages through the production process. This contrasts with a retail sales tax where a series of intermediate exemptions is intended to cause tax to be levied only on the final retail sale.

The tax fails the transparency test. While the tax is measured by sales, the tax is typically not transparent to the purchaser, but instead is absorbed by the seller as a cost of doing business. In 1997, the Tennessee General Assembly enacted Tenn. Code Ann. § 67-1-112, which effectively codified a previous
rule permitting a taxpayer to pass the business tax along to customers. Because the tax "collected" is required to be added back to gross receipts for purposes of determining the tax base for both business tax and sales tax (thus making both more susceptible to calculation errors), the passing along of this tax is not widely done, except among retailers of automobiles or other large ticket items.

The tax is not economically neutral—it can and does influence location decisions. Tennessee has promoted itself as a distribution hub within one day's drive of two-thirds of the U.S. population. It is home to Federal Express Corporation in Memphis and is bordered by eight states. While most states have income and franchise taxes similar or comparable to the Tennessee franchise and excise taxes, very few have a tax comparable to the Tennessee business tax that is in addition to the income/franchise tax and sales tax. The state is at risk of losing warehousing facilities to its border states as a result of the expansion of the Tennessee business tax.

Location, Location, Location

As originally enacted, the Tennessee business tax allowed counties and incorporated municipalities to tax the privilege of engaging in any of the business activities enumerated in the Act where such business activity was "carried on." The Business Tax Act requires both a license at each business location and an annual return to report gross sales for each location. If a business was located inside a city that imposed the tax, the business was required to obtain a license for both the city and the county, and was required to pay tax on gross receipts to both governments. Businesses located outside the city limits were only required to obtain a county license and pay taxes on gross receipts to the county government, provided the county imposed the tax. Special rules applied for businesses located in jurisdictions imposing the tax and making sales into other jurisdictions without establishing a location. Of Tennessee’s 95 counties, 92 had passed the required resolution adopting the business tax. As of 2013, only Clay, Claiborne, and Morgan Counties had not adopted the business tax.

Prior to September 2016, Tenn. Comp. R. & Regs. 1320-4-5-.28 provided administrative guidance on requirements for locations and outlets where business was "carried on." The regulation did the following:

- reaffirmed the location-based reporting methodology noted above;
- provided a "throwback rule" for businesses that extended operations outside of their location, requiring such sales to be reported on that location's return;
- excepted out-of-state businesses from the business tax if there was no location in the state; and
- instructed that "peddlers" selling goods and services "on the spot" were subject to the business tax.
This rule was significantly rewritten in September 2016 to account for various law changes discussed more fully herein.

In *Westinghouse Electric Corp. v. King*, 678 S.W.2d 19 (Tenn. 1984), the Tennessee Supreme Court concluded that in order to subject an entity to business tax, the entity must be doing business in Tennessee such that its in-state activities are contributing to the establishment and maintenance of its in-state market. The court found that the taxpayer’s maintenance of marketing offices in Tennessee was sufficient presence to subject it to the business tax with regard to its contracting activity in a jurisdiction other than the location of its principal office.

Thus, to be subject to the Tennessee business tax prior to 2014, a "person" was first required to have an "established place of business" in the state. While the Department noted in Tennessee Letter Ruling 99-07 that the term "established place of business" was not defined by statute, the Department relied on the definition set forth in Black's Law Dictionary: "[A] ‘regular’ place of business is one where business is carried on regularly, and not temporarily, or for some special work or particular transaction, while an 'established' place of business must be a permanent place of business and a ‘regular and established place of business’ is one where the same business in kind, if not in degree, as that done at the home office or principal place of business, is carried on[]."

In Tennessee Letter Ruling 99-32 (Dec. 7, 1999), the Department of Revenue analyzed the application of Tennessee business tax and excise tax in a situation in which a taxpayer had no physical location in the state, but used a third-party warehouseman in Tennessee to pick and pull orders for delivery to customers within and without Tennessee. The Department determined that the taxpayer was subject to business tax in the locality where the sales were made unless an exemption applied. The ruling did not address administrative practicalities, however, such as whether a city or county clerk would actually grant a license to a business whose only presence in the state was the location of inventory in a third-party warehouse.11

In Tennessee Letter Ruling 00-35 (Oct. 30, 2000), the Department addressed the application of the business tax to a service provider coordinating milk deliveries between dairy farmers and various processing plants. The Department opined that if the provider of these services had an office outside the state and had no other presence in Tennessee, aside from the occasional visit to processing plants in the state by its staff, it was not subject to the business tax. The Department also reiterated that for the business tax to apply, a taxpayer must have an office in the state. In arriving at its conclusions, the
Department looked at the services being provided—the coordinating of milk deliveries—to determine where the business activity of the taxpayer was "carried on."

Finally, in Tennessee Letter Ruling 11-40 (Aug. 9, 2011), the Department addressed the activities of a Tennessee taxpayer that sold travel packages via the telephone, Internet, and other methods, both to Tennessee customers and residents of other states. The ruling analyzed the importance of some tangible physical presence in a locality for the Tennessee business tax to apply. While the taxpayer sold travel packages redeemable in several different Tennessee locations, the taxpayer’s physical presence in the state was limited to: (1) the maintenance of an office in one city; and (2) booth rental space in another city. In arriving at its decision on the taxpayer’s filing requirements, the Department stated that the taxpayer would not be considered to be doing business in a location simply because it sold tickets, vouchers, and similar items that its customers could use in that location. Rather, the Department concluded that, to be subject to tax in a particular local jurisdiction, the taxpayer must have made sales or conducted business activities from a location within that jurisdiction.

From Local to State Administration—2009

In 2009, the business tax underwent major administrative changes with the passage of 2009 Tennessee Public Acts, ch. 530. The most striking change in this legislation was the fact that annual business tax returns and payments were to be filed with the Department of Revenue rather than with the city or county government, although the requirement to obtain licenses from the city and county clerks still applied.

The compliance burden remained unchanged for the taxpayer; the only thing that changed was the location where the return was filed. In other words, a taxpayer with a location within the limits of a Tennessee city that had enacted the business tax had to file two returns for that location—one return for the city and one return for the county. A taxpayer with a location outside the limits of any Tennessee city, or inside the limits of a city that had not enacted the business tax, had to file one business tax return for that location for the county. Taxpayers with multiple locations had to file multiple returns, although locations within a taxing jurisdiction could—with permission—be consolidated (i.e., one return for all locations within a city or within a county).

Prior to this law change, city and county officials had the ability to collect delinquent taxes, although the Department of Revenue audited and collected taxes that were more than six months delinquent. Public chapter 530 repealed and replaced Tenn. Code Ann. § 67-4-719 to make it clear that the commissioner
now had this authority and had sole discretion whether to enter into a contract with the appropriate local official for delegation of collection or tax administration powers.

The change to centralized tax administration, coupled with improved technology and electronic capture of information, ushered in a new day for the Department in its ability to match sales data between tax types for Tennessee businesses. The Department launched numerous discovery-type projects at this time and shared information with various taxpayer groups about its success in uncovering taxpayers that were registered for one tax type but not another, or that reported vastly different sales levels at the state and the local level. Indeed, the Department widely promoted its voluntary disclosure program at that time and publicly advised that it expected to collect over $40 million in taxes from noncompliant taxpayers found through data matching programs at both the state and federal level.

Other changes in the legislation at this time included a requirement that a seller falling within Classifications 1 through 3 would also be classified as either a wholesaler or a retailer. The definitions for "retailer" and "wholesaler" were also amended. Generally, a retailer is a person primarily engaged in the business of making retail sales (i.e., more than 50% of gross sales are sales at retail); a wholesaler is a person primarily engaged in making wholesale sales (i.e., more than 50% of gross sales are sales at wholesale). Wholesale sales include sales to a retailer for resale; sales of industrial materials to manufacturers; and sales of tangible personal property to the state of Tennessee, city or county governments, or qualifying non-profits.

A category of sales that is excluded from business tax is sales for resale made by a wholesaler to another wholesaler. The law change also permitted a credit against the business tax for personal property taxes paid, if the property subject to the property tax is located at the place of business covered by the business tax return. The offset was limited to 50% of the total business tax.

**From In-State to Out-of-State Businesses—2013**

As Tennessee continued data mining and auditing the business tax, a policy concept began to emerge within the context of audits: the "deemed" location. As noted above, in this location-based tax, a taxpayer had to have a location from which it was making sales or engaged in business activity, or otherwise "carrying on" activities, before it could be subject to tax. The standard applied in the administration of this tax was different than traditional nexus standards. This is exemplified in Tennessee Letter Ruling 00-35, in which a taxpayer's employees were visiting various milk processing plants—thus
creating physical presence—but the taxpayer was not required to register for business tax because it did not have an office in the state. In other words, it was possible to have nexus under constitutional standards, but not be “carrying on” a business for purposes of the Tennessee Business Tax Act.

This began to change in 2012 when the Department issued various audit assessments against taxpayers that had no location in the state but made deliveries of product in their own vehicles to locations in Tennessee. These sales could be “discovered” because for sales tax purposes they may be included on a tax return, but for business tax purposes would be excluded because the taxpayer had no location in the state.

A flaw in these assessments was the potential to treat an out-of-state taxpayer with no location in the state differently from an in-state taxpayer. Recall that—prior to 2013—there were three counties that had not levied a business tax: Clay, Claiborne and Morgan Counties. If an in-state business established a location in Clay County but made deliveries in its vehicles to Madison County without establishing a location in Madison County, the sales would be “thrown back” to Clay County under the required sourcing regime. Because there was not a business tax levy in that county, no business tax would be due. Under the theory being advanced by auditors, if the same fact pattern noted above applied for an out-of-state business with no location in the state, the auditors would deem a location to occur where the sales were made in Madison County and would assess those sales for business tax.

It is well-settled that a tax which imposes a greater burden on out-of-state taxpayers than competing in-state taxpayers will be struck down under the Commerce Clause of the U.S. Constitution.\textsuperscript{17} In this case, a Tennessee business that established its presence in Clay, Claiborne, or Morgan Counties would have no obligation to pay the county business tax because the tax had not been adopted in those jurisdictions. An attempt to apply the county tax to an out-of-state business was constitutionally suspect.

The significant volume of sales originating from outside Tennessee led to the Department drafting and the state passing the “Uniformity and Small Business Relief Act of 2013,”\textsuperscript{18} which “clarifie[d]” the application of the business tax to out-of-state entities and the sourcing of sales involving multiple jurisdictions. The Act, which went into effect for tax periods beginning on or after January 1, 2014, also made other changes that “provide[d] tax relief to small businesses.” Under this new law, a widely touted measure was an increase in the business tax exemption from $3,000 to $10,000 in gross sales, which effectively removed the tax return filing requirement for very small businesses.\textsuperscript{19}
Most importantly, the law:

(1) Converted the county business tax into a state-level tax to deal with the issue of the three counties that had not adopted the business tax. The new law provided for distributions to the counties using the same methodology that existed under prior law.

(2) Added a new subsection, Tenn. Code Ann. § 67-4-717, that imposed the state-level tax on any person engaged in business in Tennessee without establishing a physical location, outlet, or other place of business if the business engaged in the following activities:

- Performed any service in the state, to the extent such service was received by a customer located in the state;
- Leased tangible personal property located in the state;
- Delivered tangible personal property to a buyer in the state, when delivered by the seller in the seller's own vehicles; and
- Purchased and subsequently sold tangible personal property in the state in a wholly in-state transaction, where the purchase and subsequent sale were accomplished through the presence in the state of the seller's employees, agents, or independent contractors acting on behalf of the seller. 20

With regard to the performance of services, under the prior law there was a deduction for services "substantially performed in other states." 21 Section 12 of the new public chapter revised that deduction and adopted a sourcing methodology to exclude from business tax receipts "sales of services that are received by customers located outside the state." 22

Economic Nexus Standards Adoption—2016

As part of the comprehensive Revenue Modernization Act of 2015, Tennessee adopted economic nexus standards for the Tennessee franchise and excise taxes and the Tennessee business tax. 23 Under these standards, a taxpayer whose total receipts from the sale in Tennessee of tangible personal property or services exceed the lesser of $500,000 or 25% of the taxpayer's total receipts during the tax period, will be deemed to have Tennessee nexus and be subject to the state-level business tax. The taxpayer is not subject to the city-level business tax unless it has a location within the city limits.

In addition, Tenn. Code Ann. § 67-4-717 was rewritten again to apply the "substantial nexus" concept noted above and to redefine and broaden the activities that would fall within the parameters of "engaged in business in this state."
Recall that Congress, in passing the Interstate Income Act of 1959, 15 U.S.C. § 38115 U.S.C. § 381 \footnote{Public Law 86-272}, established protections for certain in-state activities. Specifically, Public Law 86-272 pre-empted states from imposing a net income tax on the income derived from interstate commerce if the taxpayer’s only activities within the state were related to solicitation of orders for sales of tangible personal property and such sales were approved and filled from outside the state. Because the business tax is a gross receipts tax, the protection for sales activity in Tennessee does not apply.

**Current Challenges with the Tennessee Business Tax**

While the Tennessee business tax has been massively broadened over the last decade, the law has not been substantively changed to keep up with both tax technical and tax administrative matters. The following are part of an ever-growing list of issues that I have seen arise since 2013.

**Exemption for persons engaged in manufacturing**

Tenn. Code. Ann. § 67-4-712(b)(2) (2017) exempts from the Tennessee business tax “any person primarily engaged in the manufacture of goods, wares, merchandise or other articles of value from a location or outlet subject to ad valorem taxation” under the property tax provisions of the Tennessee Code. Generally, manufacturers are subject to Tennessee property tax.

Tenn. Comp. R. & Regs. 1320-4-5-.29(3) (1987) (“Rule 29”) narrows the statutory exemption to provide that “[s]ales of tangible personal property manufactured or processed by a manufacturer or processor, who is subject to the ad valorem tax . . . are exempt from the Business Tax if made at the manufacturing or processing location within this state.” Tenn. Comp. R. & Regs. 1320-4-5-.29(4) (1987) further provides that “[s]ales of tangible personal property manufactured or processed by a manufacturer or processor from locations other than the manufacturing or processing location where the ad valorem tax is paid are subject to the Business Tax.” In other words, if a manufacturer makes sales from a location other than its manufacturing facility, the rule would make those sales subject to business tax.

The "primarily engaged in the manufacture" provision is administered similarly to the sales tax, where a manufacturing or industrial machinery exemption is granted or denied on a location-by-location basis, as confirmed in *Tennessee Farmer’s Cooperative v. Jackson*, 736 S.W.2d 87 (Tenn. 1987).
There are several issues with this rule. First, with the application of the business tax to sales originating outside of the state, this exemption is constitutionally suspect unless it is administered in such a way that an out-of-state manufacturer is treated the same as an in-state manufacturer. The law could be discriminatory on its face because it does not subject to tax the sale of goods produced at a location in Tennessee, but does subject to tax the sale of goods produced outside the state. Under the terms of the law, the exemption only applies if a manufacturer is subject to Tennessee ad valorem taxes. A manufacturer in Kentucky that is subject to Kentucky ad valorem taxes and ships product into Tennessee from its plant location is placed at a disadvantage to its in-state counterpart. This provision could be remedied by removing the requirement that the location of product be subject to ad valorem tax, or that such tax be Tennessee ad valorem tax.

Second, the law grants the exemption to a “person”—not to the sales at a particular location. “Person” is defined to include “any individual, firm, partnership, joint venture, association, corporation, estate, trust, business trust, receiver, syndicate, or other group or combination acting as a unit, and the plural as well as the singular number.” Such rules and regulations may not enlarge the scope of either a taxing statute or an exemption. Under the plain language of the law, the exemption should apply to the sales of the entity rather than the sales at a given location.

Third, Rule 29 has the effect of discouraging expansion by manufacturers. If a good is manufactured in Tennessee and is sold by the manufacturer to a purchaser in Tennessee, then it should make no difference whether the finished goods are sold from the plant floor or from a distribution center. This makes no policy sense and actually encourages the use of warehousing facilities outside the state.

**Wholesale-to-wholesale sales**

Based on the holding in *Pfizer v. Johnson*, 2006 Tenn. App. LEXIS 44 (2006), and under the definition of “wholesale sales” set forth in Tenn. Code Ann. § 67-4-702(a)(26), sales from one wholesaler to another wholesaler are not subject to business tax. However, sales of industrial materials that are further processed are subject to business tax as wholesale sales. It is befuddling why wholesale-to-wholesale sales are excluded from business tax, but wholesale-to-factory sales are subject to the tax. The following simple examples illustrate the illogical outcomes of these policies:

- **Raw materials sold to manufacturer of automobile parts**: subject to business tax as wholesale sale of industrial materials.
- **Parts sold to manufacturer from Tennessee location where parts manufactured**: not subject to business tax if sold from plant location where produced.
• **Parts sold to manufacturer from Tennessee warehouse location**: subject to business tax.

• **Parts sold to manufacturer from out-of-state manufacturing location**: subject to state-level business tax, but this is constitutionally suspect as noted above.

• **Parts sold by manufacturer to another manufacturer to be incorporated into product**: not subject to business tax if sold from manufacturer’s plant; subject to business tax if sold from warehouse location.

• **Parts sold by manufacturer from manufacturer’s warehouse facility to a wholesaler**: not subject to business tax as a wholesale-to-wholesale sale.

• **Parts sold by manufacturer to distributor that sells directly to retailers**: subject to business tax as a wholesale sale.

These examples also illustrate the classic problem of a pyramiding tax—especially in the arena of manufacturing. For a state that has undertaken many efforts to encourage the growth of manufacturing, including the adoption of single sales factor sourcing for manufacturers, applying a gross receipts tax to the sale of raw materials is simply incongruous with that policy as well as sound tax policy.

A second issue with wholesale-to-wholesale sales is that there is no guidance provided for the manner in which a taxpayer should document that a particular sale is wholesale-to-wholesale. Unlike with sales tax, where such a sale would be documented with a resale certificate, the tax burden does not fall on the customer. Instead, absent a contract or arrangement with the customer to pass the tax through, the burden of documentation falls on the seller to track receipts. Indeed, the use of a resale certificate provides notice that the sale is, in fact, intended for resale. But for business tax, a resale certificate could indicate either a wholesale-to-wholesale sale or a wholesale-to-retail sale; thus, it does not solve the problem. The seller in a wholesale-to-wholesale scenario is presumably required to maintain some type of statement from its purchasers for sales that in some way touch Tennessee.

Expanding the business tax to include sales originating from locations outside the state has added extraordinary administrative burdens to sellers and again has set up a situation where large multistate sellers and purchasers are incentivized to plan fulfillment arrangements in such a way that a Tennessee situs is avoided. The risk could be avoided by structuring the supply chain for wholesale-to-wholesale sales to exclude transactions where title or possession occur in the state of Tennessee, as more fully described below.
Consider the following scenario: Distribution Company has warehouses located in five states, including Tennessee. Distribution Company sells to Multistate Retailer that also has multiple warehouses, including one in Tennessee. Multistate Retailer removes goods from its warehouses for delivery to stores both inside and outside Tennessee.

The sale from Distribution Company to Multistate Retailer is a "wholesale sale" under Tenn. Code Ann. § 67-4-702(a)(26)(A) (2017) because it is a sale to a retailer for resale. After the expansion of the business tax to cover out-of-state sales, the Department would advise that business tax applies as follows in this instance:

- If a sale from Distribution Company's warehouse originated in Tennessee and was delivered to Multistate Retailer's warehouse in Tennessee, the sales would be included in Distribution Company's business taxes at both the city level (if applicable) and state level for business tax.
- If a sale from Distribution Company's warehouse originated in Tennessee and was delivered to Multistate Retailer's warehouse outside of Tennessee, the sales would be excluded from Distribution Company's business taxes.
- If a sale from Distribution Company's warehouse originated outside of Tennessee and was delivered to Multistate Retailer's warehouse inside Tennessee, the sales would be included in Distribution Company's state-only business taxes.
- If a sale from Distribution Company's warehouse originated outside of Tennessee and was delivered to Multistate Retailer's warehouse outside of Tennessee, the sales would be excluded from Distribution Company's business taxes because there would be no Tennessee sale.

The last example highlights a planning opportunity in the supply chain if the use of Tennessee warehouses in the wholesaler-to-retailer transaction is avoided. Unlike sales tax, where a taxable event would occur at the point the good is delivered to the final consumer, the business tax would require receipts to be included in the tax base at intermittent steps in the supply chain. In the example, the Multistate Retailer may ultimately intend to stock Tennessee stores with the goods, but it can transport those goods directly to its stores in Tennessee without having a taxable event occur under the business tax. This illustrates the issue with tax pyramiding and how the business tax is not neutral because it influences these types of supply chain decisions.
Similar to the sales tax, business tax has always required registration at each location in Tennessee. While it is common for a seller to have a single out-of-state sales tax registration, the comparable out-of-state business tax registration has only been in place since 2014.

One question that has arisen involves the separate registration requirement for disregarded LLCs. Recall that while entities with limited liability protection are generally subject to the Tennessee franchise and excise taxes, the law provides that a single member LLC (“SMLLC”) that is disregarded for federal income tax purposes will also be disregarded for franchise and excise tax purposes if its single member is a corporation. Many out-of-state businesses view the Tennessee business tax as more aligned with the registration requirement for franchise and excise taxes than with the sales tax because an SMLLC would be included as part of its corporate owner’s filing.

The Department has provided informal guidance that SMLLCs are expected to have their own business tax licenses and registrations using their federal employer identification numbers (“FEINs”). While this approach is consistent with location-based reporting requirements that have been in place under the Tennessee business tax since its inception, such a requirement continues to place added compliance burdens on multistate entities.

A second issue that has arisen involves a multistate seller with one FEIN that uses both in-state and out-of-state locations to make Tennessee sales. There is currently nothing in the law or the rules that addresses correct reporting for this very common scenario. In this situation, the Department has advised taxpayers that the correct way to report tax is for all out-of-state locations to consolidate sales on one state-level business tax registration number, and for each in-state location to report based on sales from the in-state location at the state level and city level, if the location is within a city limit. For an out-of-state business making sales originating from outside the state, if sales into a county are less than $10,000 in the reporting period, those sales do not have to be included in the business tax return. In contrast, sales originating from an in-state location that are made into another city or county will have to be “thrown back” to the city or county where the seller has a location and be reported on that location’s return(s), regardless of whether the $10,000 threshold is met. Again, this describes informal guidance provided by the Department.

Finally, an issue that is related to the second issue noted above has arisen around data matching programs between sales tax and business tax. For example, say a business has one store inside the
state. The business dutifully reports all sales delivered to a customer in Tennessee on the return for that
store, rather than having a separate registration for sales originating out of state. When the Department
runs its data matching programs, it will pick up all sales reported on the sales tax and include those in a
proposed assessment on a business tax base for both city- and state-level returns. The sales originating
from outside the state generally would not have been subject to business tax at all prior to 2014. The
sales may not be subject to business tax until 2016—when economic nexus standards began to apply
unless the in-state location facilitated the out-of-state sales—and then only at the state level. While the
Department is working with taxpayers to straighten out the filings, this can be an administrative mess to
sort through and requires a taxpayer to have strong records supporting the origination point of sales.

Old definitions and inconsistent sourcing methodologies

As noted above, the Tennessee business tax differs from the sales tax in the former’s very broad base.
Sales of services are generally subject to business tax unless specifically exempt. Sales of services are
taxable under Classification 3, while the vast majority of the sales of tangible personal property fall within
Classifications 1 or 2. While the definitions in the sales tax laws have been changed many times,
definitions that apply to Tennessee business tax are still stuck in the 1970s.

Tangible personal property: Under the sales tax law, the definition of “tangible personal property” was
amended to include prewritten computer software. The definition in the Business Tax Act has not been
updated. Presumably the sale is included in the receipts as the sale of a service under Classification 3.

Digital products: Under the sales tax law, Tennessee has levied a tax on specified digital products where
such products are transferred to or accessed by subscribers or consumers in the state. These products
are separately defined and not included within the more general tangible personal property definition.
There is currently no guidance as to how the state would treat the sale of these products for purposes of
the Tennessee Business Tax Act. If one assumed that the sale of such items would fall within the general
“services” category, then such a sale could only be sourced to Tennessee if it was “delivered” within the
state.

Remote access to software: In 2015, Tennessee amended the sales tax law to deal with the issue of
computer software that is never delivered in Tennessee, but is accessed by a user in the state. 2015
Tennessee Public Acts, ch. 514, provides that a taxable use of computer software in Tennessee includes
the access and use of software that remains in possession of the seller and is remotely accessed by a
customer for use in Tennessee. This provision explicitly equates the access to software in a remote
location by a customer with an address in Tennessee with the sale or licensing of the software and electronic delivery of the software for use in Tennessee.  

No such provisions exist in the Tennessee Business Tax Act. Access to software is not the same as delivery of the software. In the sales tax law, the legislation explicitly addressed this sourcing issue. With respect to the Tennessee Business Tax Act, remotely accessed software that does not reside in Tennessee, but is accessed from Tennessee, likely falls within the "services" catch-all classification, but it should not be included within gross sales sourced to Tennessee because nothing is delivered in Tennessee.

Manufacturing: "Manufacturing" and "industrial machinery" are broadly defined terms for purposes of Tennessee sales and use tax. However, manufacturing is not defined in the Tennessee Business Tax Act. Tenn. Comp. R. & Regs. 1320-04-05-.13(9) (2017) defines a "manufacturer" as "those persons engaged in the businesses described in Division D of the Standard Industrial Classification (SIC) Index of 1987, as amended." The categories of manufacturing that existed in 1987 do not cover many of the types of fabrication and production that exist today.

Furthermore, Tennessee created a favorable sales tax exemption for equipment and machinery used in research and development activities in 2015. It is not clear if a person engaged in research and development activities could qualify as a manufacturer under the Business Tax Act. The Business Tax Act exempts services furnished by nonprofit educational and research agencies. At a time when many research activities are conducted by for-profit entities that advance knowledge or technology in a scientific or technical field of endeavor, it is unclear why a policy exists that would potentially subject the sales of such research and development services to business tax.

Telecommunication services: Exempt from the business tax under Tenn. Code Ann. § 67-4-712(b)(3) is any person taxable under another provision of "part 4 of this chapter with respect to receipts taxable under such provisions[.]" Prior to July 1, 1989, telephone and telegraph companies were subject to the gross receipts tax under Tenn. Code Ann. § 67-4-407. At the time the business tax was enacted in 1971, mobile telecommunication services were not sold to the public. The only telephone service available at that time was the regulated telephone service that was subject to the gross receipts tax under Tenn. Code Ann. § 67-4-407.

In 1989, in an effort to modernize the approach to taxation of the rapidly evolving communications industry and conform to the U.S. Supreme Court’s decision in Goldberg v. Sweet, 488 U.S. 252 (1989),
the Tennessee General Assembly repealed the gross receipts tax levied in Tenn. Code Ann. § 67-4-407 and subjected the newly defined “telecommunications services” to the sales tax. Consistent with Goldberg, Tennessee adopted a sourcing methodology for sales tax by which receipts from telecommunications services would be sourced to Tennessee if the call either originated or terminated in Tennessee and the call was charged to a “service address” in Tennessee. There was no change in the business tax at that time. With the growth of mobile wireless telecommunications services, it was becoming increasingly difficult to determine whether wireless calls met the Goldberg rule of origination or termination and service address in a state. Moreover, single rate plans were growing in popularity, which led to a decrease in the need to track individual calls. This led to the passage of Public Law 106-252, the Federal Mobile Telecommunications Sourcing Act (“MTSA”), which established a national framework for how receipts from the provision of mobile telecommunications service should be sourced for state and local tax purposes. In 2002, Tennessee conformed its sales tax laws to adopt the sourcing provisions of the MTSA. This law requires that state and local governments apply a uniform sourcing rule based on the customer’s primary place of use in levying a tax measured by charges to a customer. Again, there was no change in the business tax at the time the MTSA changes were adopted.

While the state has made the necessary legislative changes to be in compliance with the sourcing methodology required by MTSA for sales tax purposes, the Tennessee Business Tax Act has made no such changes. It is questionable whether these services even should be subject to the business tax since, again, they did not exist at the time the Tennessee Business Tax Act was enacted. Regardless, attempts to apply the Business Tax Act to communication services would likely violate the MTSA because they are for mobile communications and measured by the charge to the customer.

*The home office conundrum and the deemed location:* In this day and age of telecommuting, a question that is frequently asked is, “Does a home office equal a location?” The good lawyer answers, “It depends.”

The location issue matters, of course, because a location determines if a taxpayer pays the business tax once or twice—at the state level or at both the state and city level (assuming the location is within city limits).

When I sought guidance on this issue after the 2013 law changes, I was referred to the “peddler” provisions of Tenn. Comp. R. & Regs. 1320-4-5-.28(4) (Sept. 2000) which, again, focus on “on the spot
sales" (from what would likely have been the encyclopedia or vacuum cleaner salesperson at the time the rule was originally adopted in 1974). This really has nothing to do with a situation in which people may be working from remote locations and performing activities that have nothing to do with sales generation in the state. It also does not address a Public Law 86-272 scenario in which solicitation may occur in the state, but sales are approved and delivered from outside the state.

As noted above, when the 2013 law changes were enacted, Tenn. Code Ann. § 67-4-717 defined what constitutes "engaging in business" in Tennessee without setting up a physical location: performing any service in Tennessee, to the extent such service is received by a customer located in Tennessee; and purchasing and subsequently selling tangible personal property in Tennessee in a wholly in-state transaction, where the purchase and subsequent sale are accomplished through the presence in Tennessee of the seller's employees, agents, or independent contractors acting on behalf of the seller.

Similarly, 2015 Tennessee Public Acts, ch. 514, Section 5 repealed and replaced Tenn. Code Ann. § 67-4-717(a) with the following relevant sections:

(1) Except as otherwise provided in this part, all persons with a substantial nexus in this state during the tax period and engaged in this state in any vocation, occupation, business or business activity set forth as taxable under § 67-4-707(1)-(5), with or without establishing a physical location, outlet or other place of business in this state, shall be subject to the tax levied by § 67-4-704. For purposes of this section, the phrase 'engaged in this state' shall include, but not be limited to, any of the following:

(A) The sale of tangible personal property that is shipped or delivered to a location in this state;

(B) The sale of a service that is delivered to a location in this state; [or]

(C) The leasing of tangible personal property that is located in this state . . . .

(2) All persons that are subject to the tax levied by § 67-4-704 and have a physical location, outlet, or other place of business within a municipality in this state shall be subject to the tax levied by § 67-4-705. Persons that do not have a physical location, outlet or other place of business within a municipality in this state shall not be subject to the tax levied by § 67-4-705.

To summarize, Tenn. Comp. R. & Regs. 1320-4-5-.28, as it read prior to September 2016, required business tax to be paid for every location or place of business in Tennessee. It excepted businesses with no location in Tennessee, and it required peddlers making sales of goods or services on the spot to pay business tax. The 2013 and 2015 law changes imposed, and then expanded, tax in situations where out-of-state businesses have no location in the state. Also recall Ruling 99-32, where the Department found nexus and presumably "deemed a location" where inventory was held at a third-party warehouse.
Taking all of this into account within the context of a home office, the following seem like logical outcomes for the home office scenarios set forth:

**Multistate seller with greater than $500K in sales of goods or services delivered in Tennessee, but no place of business in Tennessee, and employee(s) with home offices who are not involved in sales of goods or services.** The seller should have no obligation for city or county licenses and should only report business tax for the period post-2016, unless the seller delivers goods in its own trucks.

**Multistate seller with greater than $500K in sales of goods or services delivered in Tennessee; employee(s) with home offices who call on customers, but sales orders received by such employees are approved and delivered from outside Tennessee.** This should be the same answer as the preceding because the employee is not making sales on the spot and should not fall within the “peddler” designation of the old rule. The seller should have no obligation for city or county licenses and should only report business tax for the period post-2016, unless the seller delivers goods in its own trucks or has other employees entering the state to perform services in the state. If the latter, then the seller would likely fall within the requirements to pay out-of-state business tax after January 1, 2014, even if the sales are below $500K.

**Multistate seller with no location in Tennessee, and employee(s) with home offices within a city limit that enter into contracts for sales of goods from their home or at customer locations, sell goods out of their home, or perform services at customer locations in Tennessee.** This would seem to fall within the parameters of Tenn. Comp. R. & Regs. 1320-4-5-.28(4) (Sept. 2000), where the Department took the position that the business had to be licensed—presumably at the home location—and pay Tennessee business tax at both the city and county level for periods prior to 2014, and at both the city and state level post-2014.

Again, the better—but unclear—policy answer on the matter above is that a home office where an employee is not holding himself or herself out as engaging in sales on behalf of the business from that location should not subject his or her employer to the city-level business tax. While this answer has support in the law and administrative guidance, it is not necessarily the one that auditors are applying at this time. This matter is one that is ripe for clarification with a policy that makes business sense.

### Conclusion

The Tennessee Department of Economic and Community Development's current “Mastered in Tennessee” campaign touts the many benefits of doing business in Tennessee, stating “Tennessee
knows how to succeed in business.” The enumerated benefits of locating in Tennessee can easily be
undercut by outdated tax laws, such as the business tax. Over the course of the past several years,
advocates to modernize the tax have instead led to a broadening tax base, significantly increasing the
group of sellers liable for the tax. These businesses often only learn about the existence of the business
tax due to “gotcha” enforcement after they have failed to comply. This “quiet” tax is so unknown, it does
not even make the list of taxes on the Tennessee Department of Economic Development’s website
alerting people to the taxes that they should be aware of when moving to the state.

As noted by the Tax Foundation, gross receipts taxes are rarely used by the states, and the majority of
states repealed such taxes in the 1920s and 1930s, replacing them with retail sales taxes.44 Those states
do have gross receipts taxes generally forego a corporate income tax. Tennessee has all of the
above. Rather than repeat some of the hasty legislative responses of 2013 and 2015, extending the tax to
out-of-state taxpayers uncovered in audit scenarios, lawmakers should take a thoughtful approach to the
business tax. The question that needs to be asked is whether this is truly the tax policy that the state
intends to impose—a policy that promotes tax pyramiding, is not transparent, influences business location
decisions and supply chain structures, and has a high cost of compliance relative to its benefit. If
Tennessee policymakers believe the tax is necessary, despite these flaws, then a revamp and
modernization of the law is in order. There should be more harmony with the Retailer Sales Tax Act
(given that the tax is reported based on gross sales), an exclusion for certain business inputs should be
enacted, and there should be a simpler compliance structure put in place.

---

1 The term “Frankensystem” is, of course, a rather pejorative reference to the brilliant Mary Wollstonecraft
Shelley’s masterpiece “Frankenstein.”


4 “Dominant business activity” is defined as the “major and principal source of taxable gross sales of the

5 The classifications generally follow the types of wholesale and retail trade classifications set forth within
the Standard Industrial Classification Code with the various types of trade divided somewhat randomly
among Classifications 1 through 3, and the services set forth in Division H of the SIC Code included
within Classification 3. Classification 4 covers the business or performance of contracting activities and
Classification 5 is limited to industrial loan and thrift companies required to obtain a certificate and a
license under title 45, chapter 5 of the Tennessee Code Annotated.
Tenn. Code Ann. § 67-1-112 (2017) provides: “the business tax is a privilege tax imposed upon persons engaged in various businesses and activities in the state. If a dealer invoices the business tax as a separate item and passes it on to the dealer's customers, then the tax shall be added to the gross receipts and be used in determining the tax base for both business tax and sales and use tax purposes.”


Id.

Tenn. Comp. R. & Regs. 1320-4-5-.28 (September 2000) provided:

(1) The Business Tax is applicable to each place, location or outlet in the state from which business is carried on. This means that a business which engages in business activity in several places, in different locations and through different outlets, must pay the minimum tax on each place, location or outlet; and it must report loss sales and tax due for each separate location. The fact that a business has several outlets in a single county or municipality is immaterial. Such business may upon request submit a consolidated report to cover all such outlets in one county or city, however, a breakdown of sales by each outlet must accompany such consolidated report. (See 1320-4-5-.52(2)).

(2) Subject to the exceptions enumerated hereinafter, persons subject to the Business Tax operating from an established place of business in one county who extend their operations into other counties and/or municipalities without establishing an office, headquarters or other place of business therein shall not be subject to the Business Tax in such other counties and/or municipalities. Tax on total receipts from all taxable sales shall be due to the county and municipality, if any, in which the established place of business is located.

(3) Excepted from the rule as stated in subparagraph (2) are:

a) Persons with no established place of business in this state.

b) Contractors with taxable receipts of $50,000 and out-of-state contractors.

(4) Persons who make sales and delivery of merchandise of services concurrently and on the spot to their customers are deemed to be 'peddlers.'

a) All peddlers, both full-time and part-time, must pay the Business Tax measured by the applicable rate of tax as provided in the Business Tax Act. Full-time peddlers must pay the minimum tax and possess the license as provided for in the Act; part-time peddlers are not required, however, to pay the minimum tax or possess the license as provided for in the Act.

b) A full-time peddler is one who is regularly engaged in business somewhere as a peddler as herein defined. Persons regularly engaged in a seasonal business somewhere are full-time peddlers during the seasonal period.

c) A part-time peddler is one who does not devote his full-time regularly as a peddler. A person does not become a part-time peddler merely because he remains in a county or municipality for a few days and then moves on to a different locality.
Indeed, prior to the Department taking over administration of the business tax in Tennessee in 2010, taxpayers generally sought answers to tax questions from the clerk in each city or county. During this time, if a taxpayer asked whether it was required to be registered for business tax if it only had inventory at a third-party location, it is highly likely the clerk would have answered no because the business did not have an office or other place of business where it held itself out as making sales.

While business tax return data were previously available to the Department, which had the ability to audit those data when it was otherwise auditing taxpayers, there was no centralized data collection. Thus, an auditor would have to retrieve this information from the local clerk's office, usually in a paper format.

The Department generally does not publish the level of collections produced from non-compliance for a particular tax. From the annual tax collections report, from FY 2009 to FY 2017, business tax collections grew from $136.1 million to $172.5 million, a growth of approximately 26%. In that same period, sales tax collections have grown from $6.4 million to $8.5 million, a growth of approximately 33%. See https://www.tn.gov/revenue/tax-resources/statistics-and-collections/collections-spreadsheets-by-fiscal-year.html.


Classification 4, which covers contractors, has always had the concept of a deemed location for contractors who receive more than $50,000 of compensation from contracts in a county or municipality other than where they are domiciled. In that case, the contractors were required to file a return for their "deemed" location. What became new in 2012 and 2013, typically through an audit assessment, was the idea that this concept of "deemed" location would apply for out-of-state sellers of goods and services.


A cynic might view this as a way to eliminate a filing requirement where the businesses were paying less in tax than the cost of administration of the tax.


22 Tenn. Code Ann. § 67-4-711(6) (2014). Other changes in the Act included changes to the filing period and methodology as well as electronic filing requirements, including authority to change the tax period to correspond to the taxpayer's fiscal year. The due date for calendar-year taxpayers was changed to April 15 regardless of classification. All business tax filings were required to be made electronically after January 1, 2014. Id. The Act also permitted the commissioner to accept a single, combined electronic filing that includes all the information required by the commissioner to determine the amount of tax that is properly due and to allocate it to each jurisdiction. This was considered a major benefit to multi-outlet businesses, but the sales data is still required to be reported in such a way that the Department can determine sales within each jurisdiction.

24 See Armco Steel, 467 U.S. 638.


26 See Covington Pike Toyota, Inc. v. Cardwell, 829 S.W.2d 132, 135 (Tenn. 1992); Volunteer Val-Pak v. Celauro, 767 S.W.2d 635, 637 (Tenn. 1989); and Coca-Cola Bottling Co. v. Woods, 620 S.W.2d 473, 475-76 (Tenn. 1981).

27 See Tenn. Comp. R. & Regs. 1320-4-5-.33(2), which provides that "deliveries of tangible personal property or services to customers outside the State of Tennessee . . . are sales exempt from the Business Tax."

28 The Department has provided informal guidance indicating that all sales originating from outside Tennessee can be aggregated and reported on one out-of-state business tax account that reports business tax at the state level only.


36 One could say that this definition is an improvement over the definition that existed prior to September 2016. At that time, "manufacturer" was defined as one that fell within the SIC code of 1967.

37 See 2015 Tennessee Public Acts, ch. 504, amending the definition of "industrial machinery" in Tenn. Code Ann. § 67-6-102 to include machinery, apparatus and equipment necessary to and primarily for research and development.


39 1989 Tennessee Public Acts, ch. 312. See also Prodigy Services Corp. v. Johnson, 125 S.W.3d 413 (Tenn. Ct. App. 2003), in which the Tennessee Court of Appeals noted the following state of the law relative to taxing and regulating telecommunications services when the Tennessee General Assembly adopted Public chapter 312: "In that year it became clear that states could tax interstate telephone calls. See Goldberg v. Sweet, 488 U.S. 252, 109 S. Ct. 582, 102 L. Ed. 2d 607 (1989). The debates in the legislature suggest that the members intended to take advantage of that opening on a broad front. Hence, the examples in Tenn. Code Ann. § 67-6-102(31)(C) (Supp.2002): 'telephone service, telegraph service,
telephone service sold by hotels or motels to their customers or to others, telephone service sold by
hospitals to their patients or to others, WATS service, paging service, and cable television service sold to
customers or to others by hotels or motels."

40 According to CTIA-The Wireless Association, there were only 340,213 cell phone subscribers in 1985,
expanding to 10 million customers by 1992. It is logical to infer that, at the time of the legislative change in
1989, no one even thought about the local Business Tax Act.


43 See https://youtu.be/-jk-kbDNDdUM.

44 E.g., Delaware, Nevada, Ohio, Texas and Washington. See "The Return of Gross Receipts Taxes,"

© 2018 Thomson Reuters/Tax & Accounting. All Rights Reserved.