# TENNESSEE DEPARTMENT OF REVENUE
# REVENUE RULING # 02-22

## WARNING

**Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.**

## SUBJECT

Whether the taxpayer was doing business in Tennessee for the purpose of applying the franchise and excise taxes.

## SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

## FACTS

The taxpayer was established as a Tennessee corporation in 1994 and has filed zero, or no activity, franchise and excise tax returns with Tennessee from 1994 through 1999. The taxpayer owns and operates [BUSINESSES] located in [NUMBER] other states. The taxpayer does not currently own or operate any [BUSINESSES] in Tennessee, and it did not own or operate any [BUSINESSES] during 1997, 1998 and 1999 (the ruling period).

The taxpayer is a subsidiary of the parent, a [BUSINESS] corporation legally and commercially domiciled in Tennessee. The parent was established in 1977 to develop, own and operate [BUSINESSES] under certain brand names. In 2000, the parent conducted an internal review of operations and determined that one of its Tennessee employees, a regional manager, performed the majority of his or her services for, on behalf of, or in the name of the taxpayer during the ruling period. Subsequent to this internal review, the parent legally transferred the Tennessee employee's payroll and office property to the taxpayer to more accurately reflect the reality of both entities' business operations. As a result of the transfer of Tennessee property and payroll to the taxpayer, the taxpayer will no longer file zero or minimum activity returns in Tennessee. Instead, the taxpayer will apportion its income and net worth to Tennessee using a three-factor apportionment formula consisting of a property factor, a payroll factor and a double weighted sales factor in accordance with Tenn. Code Ann. §§ 67-4-2014 and 67-4-2111.

As previously noted, the taxpayer owns and operates certain brand name [BUSINESSES] in [NUMBER] other states. As a standard policy of the taxpayer, each of its brand name [BUSINESSES] employs a general manager who is responsible for day-to-day operations at the location where they are employed. As a standard policy of the parent, corporate-owned brand name [BUSINESSES] are further managed by a parent-employed regional manager who directly supervises the general manager of each [BUSINESS] within their region.

Because of the hands on role required of regional managers, the parent generally limits its oversight to between four and six [BUSINESSES] within a particular geographic area. Due to the location of the taxpayer's [BUSINESSES], one regional manager oversaw all of the taxpayer's [BUSINESS] properties in the [NUMBER] states outside of Tennessee during the ruling period.

The effect of the taxpayer's and the parent's reporting structure was that during the ruling period all of the taxpayer's [BUSINESS] managers were directly supervised by a single regional manager who worked out of the parent's office in Tennessee. The regional manager, technically employed by the parent, was responsible for implementing and maintaining the high quality, performance and profitability standards set for each of the taxpayer's [BUSINESSES].

As part of his or her oversight duties, the parent's Tennessee-based regional manager was responsible for developing annual operating budgets for each of the taxpayer's [BUSINESSES]. To more effectively perform this function, the regional manager received and analyzed weekly statements and invoices from each taxpayer [BUSINESS] to ensure that they were operating within their respective budgets. As part of his or her budget oversight authority, the Tennessee-based regional manager was authorized to provide marketing support for the taxpayer's [OPERATIONS] that were under-performing, as well as those that did not have a full-time salesperson. Based on operating parameters set by the parent's senior management and the information contained in the weekly statements, the regional manager issued directives regarding operational policies and procedures for each [BUSINESS OPERATION].

The directives were addressed to the individual [BUSINESS] managers employed by the taxpayer and encompassed all major aspects of each [BUSINESS] operations. Topics covered by the directives ranged from issues as broad as guidelines concerning the overall visual aspects of the [BUSINESS] to issues as narrow as orders for a specific remodeling project at a specific [OPERATION]. Even issues as fundamental as the [PRICE] charged by the taxpayer's [BUSINESS] were decided by the Tennessee-based regional manager in conjunction with the parent's senior management. This reporting hierarchy inevitably meant that throughout the ruling period, all important corporate decisions were made for, or on behalf of, the taxpayer's [BUSINESSES] by a Tennessee-based employee of the parent in conjunction with the parent's national office.

In order to further ensure that the taxpayer's brand name [BUSINESSES] were operated according to the regional manager's guidelines, each taxpayer [BUSINESS] manager was required to attend an annual three-day training course in Tennessee. During 1997 and 1998 the course was taught at the parent's brand name [BUSINESS] located in Tennessee. The content of the training sessions varied from year to year according to the needs identified by the parent's senior management and addressed topics such as brand name best practices, human resource issues and the operation of a brand name proprietary [DESCRIPTION] system.

In 1999 the parent hired a National Director of Training. Subsequent to the hiring of its National Director, the parent standardized the contents of its training sessions and began to offer these sessions to general managers from all different [BUSINESS] chains. The training sessions are currently offered once every two months and address a variety of timely industry issues. In 1999 and in all subsequent years, the taxpayer's [BUSINESS] general managers were only required to attend the Tennessee-based training once, usually during the first session available after their date of hire.

In addition to the services provided for, or on behalf of, the taxpayer by the parent's Tennessee-based regional manager, the taxpayer also had these further contacts with Tennessee during the ruling period. During 1997, 1998 and 1999, an individual who was both Chief Financial Officer for the parent and Corporate Treasurer for the taxpayer, as well as two other Tennessee-based taxpayer Board members, outlined and implemented corporate strategy while in Tennessee. All of the taxpayer's books, tax, business and insurance records were kept in Tennessee. The taxpayer's payroll was processed through the parent's national office in Tennessee. The taxpayer's Board of Directors held its annual meetings in Tennessee, and the taxpayer's legal counsel was in Tennessee.

Finally, the brand name national directory lists each of the taxpayer's [BUSINESSES] with the [BUSINESS] physical address as well as a Tennessee address with a [TENNESSEE] area code telephone number. This Tennessee address and area code show up on all of the taxpayer's tax returns and correspondence.

During the ruling period, there was no formal management agreement in place between the parent and the taxpayer. However, the taxpayer, like all of the parent's operating entities, was allocated a portion of the corporate overhead incurred by the parent.

## QUESTION

Based on the facts provided, was the taxpayer doing business in Tennessee during 1997, 1998 and 1999?

## RULING

Yes. Based on the facts provided, the taxpayer was doing business in Tennessee during 1997, 1998 and 1999.

## ANALYSIS

Doing business in Tennessee is a privilege that is taxable under both the franchise tax and the excise tax. Tenn. Code Ann. §§ 67-4-2104 and 67-4-2005. Both the franchise tax and the excise tax are levied on entities doing business in Tennessee. Tenn. Code Ann. §§ 67-4-2105 and 67-4-2007. In the context of the franchise tax law and the excise tax law,

> "Doing business in Tennessee" or "doing business within this state" means any activity purposefully engaged in, within Tennessee, by a person with the object of gain, benefit, or advantage, consistent with the intent of the general assembly to subject such persons to the Tennessee franchise/excise tax to the extent permitted by the United States Constitution and the Constitution of Tennessee. Tenn. Code Ann. § 67-4-2004(7)(A).

The Federal government has established by statute the following restrictions on the ability of a state to impose a net income tax on the income derived within the state:

> (a) Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act [enacted Sept. 14, 1959], a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> > (1) The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
> >
> > (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) Domestic corporations; persons domiciled in or residents of a State. The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to—

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) Sales or solicitation of orders for sales by independent contractors. For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

(d) Definitions. For purposes of this section—

(1) the term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and

(2) the term "representative" does not include an independent contractor. 15 U.S.C.S. § 381.

This Federal statute does not apply to the facts of this ruling request. This ruling request does not involve the solicitation of sales of tangible personal property.

Because the activities in question were done purposefully and with the object of gain, benefit, or advantage, and because 15 U.S.C.S. § 381 does not apply, the determinative issue is whether subjecting the taxpayer to the Tennessee franchise tax and excise tax is constitutionally permitted. The power of a state to impose a tax on an entity is limited by the United States Constitution. Quill Corporation v. North Dakota, 504 U.S. 298 (1992). Both the Due Process Clause and the Commerce Clause impose limits on the taxing power of a state. Id. at 305.

The Due Process Clause of the United States Constitution requires that the taxpayer have "minimum contacts" with the taxing state in order for the taxing state to impose its tax. Id. at 307. If an entity's contacts with the taxing state make it reasonable, in the context of our federal system of government, to require the entity to defend a lawsuit in the taxing state, the Due Process Clause is satisfied. Id. If a potential lawsuit against the taxpayer is reasonably foreseeable in the taxing state, the Due Process Clause is satisfied. Id. The taxpayer's physical presence in the taxing state is sufficient for jurisdiction under the Due Process Clause. Id. The taxpayer's various contacts described in the facts provided establish that the taxpayer had physical presence in Tennessee sufficient to satisfy the Due Process Clause during the ruling period, and it is reasonably foreseeable that the taxpayer could have been sued in Tennessee during the ruling period. The same facts that are discussed below regarding the Commerce Clause satisfy the requirements of the Due Process Clause. The Due Process Clause did not bar Tennessee from imposing its franchise tax or excise tax on the taxpayer during the ruling period.

The Commerce Clause of the United States Constitution grants to Congress the power to “regulate Commerce with foreign Nations, and among the several States.” U. S. Constitution, Article I, § 8, cl. 3. Although the Commerce Clause does not explicitly limit the power of the states, the United States Supreme Court has held consistently that the Commerce Clause implicitly limits the power of states to interfere with interstate commerce. <u>Quill Corporation v. North Dakota</u>, 504 U.S. 298, 309 (1992). This implicit limitation on the power of states to interfere with interstate commerce is known as the “negative” or “dormant” Commerce Clause. <u>Id</u>.

The negative Commerce Clause imposes limitations on state taxation. <u>Id</u>. One of the limitations is that there must be a “substantial nexus” between an entity and the taxing state in order for the taxing state to tax the entity. <u>Id</u> at 311. The substantial nexus requirement is satisfied by the physical presence of the entity in the taxing state. <u>Id</u>. at 317; see also <u>J.C. Penney National Bank v. Johnson</u>, 19 S.W.3d 831, 839 (Tenn. App. 2000). The nexus requirement is satisfied even if the entity’s physical presence in the taxing state is unrelated to the activity that the taxing state seeks to tax. <u>National Geographic Society v. California Board of Equalization</u>, 430 U.S. 551, 560 (1977).

In <u>Reader’s Digest Association v. Mahin</u>, 255 N.E.2d 458, 460 (Ill. 1970), the entity owned a subsidiary corporation whose employees solicited advertising for the entity’s magazine. The subsidiary and its employees were located in the taxing state. <u>Id</u>. The Court held that the physical presence of the subsidiary corporation’s employees and the benefits that flowed from their activities to the entity were adequate to justify imposition of the state tax on the entity. <u>Id</u>. The significance of this case in the context of this ruling request is that the employees that established the entity’s physical presence in the taxing state were employees of the entity’s subsidiary rather than employees of the entity. The efforts of the employees of the entity’s subsidiary performed in the taxing state for the benefit of the entity were sufficient to establish a substantial nexus between the entity and the taxing state. The technical distinction that the employees were employees of the subsidiary rather than employees of the entity was not determinative of the substantial nexus issue.

In <u>Tyler Pipe Industries, Inc. v. Washington State Department of Revenue</u>, 483 U.S. 232, 249 (1987), the entity had no office, owned no property, and had no employees in the taxing state. The entity utilized an independent contractor located in the taxing state to perform services for the benefit of the entity. The Court held that the status of this individual as an independent contractor (rather than an employee or agent) was not sufficient to defeat the taxing state's nexus argument. Id. at 250. The physical presence of the independent contractor was sufficient to establish a substantial nexus between the entity and the taxing state. Id. at 251.

Likewise, in Scripto, Inc. v. Carson, 362 U.S. 207, 208-09 (1960), the entity had no place of business, had no property, and had no employees in the taxing state. The entity utilized "advertising specialty brokers," who had written contracts to solicit orders for the entity's products in specific territories within the taxing state. Id. at 209. The Court held that the presence of the "advertising specialty brokers" in the taxing state was sufficient to create a substantial nexus between the entity and the taxing state. The formal distinction of the person as independent contractor rather than employee or agent was not constitutionally significant. Id. at 211. Therefore, in the context of this ruling request, the formal distinction that the person located in Tennessee and performing services for the benefit of the taxpayer was an employee of the taxpayer's parent rather than an employee of the taxpayer is not constitutionally significant. This conclusion is reinforced by the fact that the taxpayer was allocated a portion of the parent's overhead expenses.

In addition to the physical presence of the parent's employee performing work for the taxpayer in Tennessee, the taxpayer had other physical presence in Tennessee during the ruling period. For example, the attendance of the taxpayer's employees for training courses in Tennessee was physical presence. Also, the outlining and implementation of corporate strategy in Tennessee by two Board members and the taxpayer's Corporate Treasurer was physical presence.

In Standard Pressed Steel Co. v. Washington Department of Revenue, 419 U.S. 560, 561 (1975), the entity had one employee in the taxing state who worked out of his home. This employee was assisted by a group of other employees who visited the taxing state about three days every six weeks. The Court held that imposition of the state's tax did not violate either the Due Process Clause or the Commerce Clause. Id. at 564.

In Pearl[e] Health Services, Inc. v. Taylor, 799 S.W.2d 655, 657 (Tenn. 1990), the entity sent agents into the taxing state every six to eight weeks to show new products to retail stores. Also, the taxpayer sent quality control inspectors into the taxing state every fifteen to eighteen months to perform quality control audits. The Court held that the periodic visits of these people established a substantial nexus between the entity and the taxing state. Id. at 659. The significance of this decision in relation to the facts provided in this ruling request is that periodic visits into the taxing state, even though infrequent, can establish physical presence.

In Cole Bros. Circus, Inc. v. Huddleston, 1993 WL 190914 (Tenn.Ct.App.), the entity was physically present in the taxing state for the purpose of providing circus performances a total of 29 days during a four-year period. Id. at *2. The entity was physically present in the taxing state four days in 1985, seven days in 1986, thirteen days in 1987, and five days in 1988. Id. The Court held that the entity had sufficient physical presence in the taxing state to satisfy the requirement of a substantial nexus for the purpose of imposing the sales and use tax. Id. at *5.

In Couchot v. State Lottery Commission, 659 N.E.2d 1225, 1230 (Ohio 1996), the individual taxpayer was physically present in the taxing state twice. The individual entered the taxing state once to purchase a lottery ticket and returned to redeem the ticket for his lottery winnings. Id. Although the Court held that nexus is not required in the context of the state's personal income tax, the Court said that the individual's physical presence in the taxing state would be sufficient to satisfy the requirement of substantial nexus for the purpose of imposing the personal income tax on the individual's lottery winnings. Id. at 1231. Tennessee courts do not recognize a distinction between the sales and use tax and the franchise and excise taxes in the context of the nexus holding in Quill Corporation v. North Dakota, 504 U.S. 298 (1992). J.C. Penney National Bank v. Johnson, 19 S.W.3d 831, 839 (Tenn. App. 2000).

To the extent that the negative Commerce Clause of the United States Constitution requires that the people who are physically present in the taxing state be agents of the taxpayer, such people were the taxpayer's agents during the ruling period. See, for example, Reader's Digest Association v. Mahin, 255 N.E.2d 458, 460 (Ill. 1970). All of the taxpayer's employees who were physically present in Tennessee were the taxpayer's agents. Also, the employee of the parent corporation performed managerial services for the benefit of the taxpayer rather than for his own benefit. This individual was permanently stationed in Tennessee, and he performed the majority of his work for the benefit of the taxpayer. The taxpayer compensated for this work by paying a portion of the parent corporation's overhead. The individual was an agent for the taxpayer for the purpose of providing managerial services. This conclusion is consistent with the United States Supreme Court decisions that reject a rigid or formalistic requirement of employment or agency in the context of nexus. Scripto, Inc. v. Carson, 362 U.S. 207, 211 (1960), and Tyler Pipe Industries, Inc. v. Washington State Department of Revenue, 483 U.S. 232, 250 (1987). The taxpayer utilized Tennessee as a location of training and decision-making and accomplished these goals by means of a significant physical presence in Tennessee.

The taxpayer's physical presence in Tennessee must be greater than "a slightest presence" in order to establish a substantial nexus between the taxpayer and Tennessee. Quill Corporation v. North Dakota, 504 U.S. 298, 315 (1992), footnote 8. However, the United States Supreme Court has held that physical presence is analyzed in the aggregate. "We need not decide whether any of the nonimmune activities was de minimus in isolation; taken together, they clearly are not." Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214, 235 (1992). The facts provided by the taxpayer and the case law discussed above establish that the taxpayer's physical presence in Tennessee during the ruling period was significantly greater than a slightest presence. The taxpayer was both doing business in Tennessee and had a substantial nexus with Tennessee during the ruling period. There was no statutory or constitutional bar to the application of the Tennessee franchise tax or excise tax. Therefore, the taxpayer was subject to the Tennessee franchise tax and excise tax during the ruling period.

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DATE: 7/19/02