

TENNESSEE DEPARTMENT OF REVENUE  
REVENUE RULING # 20-08

**Revenue rulings are not binding on the Department. This ruling is based on the particular facts and circumstances presented and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.**

**SUBJECT**

The application of the Tennessee franchise tax to a foreign corporation that does not have income effectively connected to a U.S. trade or business.

**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 is a foreign entity that is classified as a corporation for federal income tax purposes. The Taxpayer is registered with the Tennessee Secretary of State to do business in Tennessee. The Taxpayer's business activities in Tennessee involve storing inventory at a toll manufacturer's facility in the state.<sup>1</sup> The Taxpayer's Tennessee inventory includes the raw materials used by the toll manufacturer, as well as finished goods. The finished goods are stored at the Tennessee manufacturer's facility until the Taxpayer ships the goods to its customers, some of which are in Tennessee. The Taxpayer states it has no income that is effectively connected with the conduct of a U.S. trade or business for purposes of Internal Revenue Code ("I.R.C.") § 864(c).<sup>2</sup>

**RULING**

Is the Taxpayer subject to the Tennessee franchise tax?

Ruling: No. The Taxpayer is not subject to the Tennessee franchise tax.

**ANALYSIS**

Tennessee imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of "[a]ll persons doing business in this state and having a substantial nexus in this state. . . or

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<sup>1</sup> In toll manufacturing, the customer company provides raw materials or semi-finished good to a manufacturer, which then completes all or a portion of the manufacturing process for the customer company in exchange for a fee.

<sup>2</sup> This ruling does not address whether the Taxpayer has income that is effectively connected with the conduct of a U.S. trade or business pursuant to I.R.C. § 864(c) (2018) and Treas. Reg. § 1.864-4 (2018). Rather, the Taxpayer is assumed to have no effectively connected income, as it indicated.

any person exercising the corporate franchise.”<sup>3</sup> Persons subject to the Tennessee franchise tax include, but are not limited to, corporations, limited liability companies, and limited partnerships.<sup>4</sup>

Pursuant to TENN. CODE ANN. § 67-4-2105(a) (Supp. 2019), persons doing business in Tennessee and having substantial nexus in the state are subject to the franchise tax. “Doing business in the state” is defined as “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.”<sup>5</sup> While the Tennessee Supreme Court has suggested that the mere holding of title to property in Tennessee is not necessarily an activity that rises to the level of “doing business” in the state, the holding of title combined with engagement in business activities related to the property does constitute “doing business” in Tennessee.<sup>6</sup>

Here, the Taxpayer’s business activities in Tennessee are not limited to merely holding title to its inventory. Rather, the Taxpayer’s activities consist of storing raw materials and finished goods, paying a manufacturer to process the raw materials into finished goods, and shipping finished goods to customers both within and without Tennessee. The Taxpayer is engaged in activity in the state with the object of gain and is therefore doing business in Tennessee.

A person has substantial nexus in Tennessee if the person has “any direct or indirect connection . . . to this state such that the taxpayer can be required under the Constitution of the United States to remit the tax imposed under this part.”<sup>7</sup> Connections that establish substantial nexus include being organized in the state or having “bright line presence,” as defined in the statute.<sup>8</sup>

However, an exception applies to a taxpayer “that is treated as a foreign corporation under the Internal Revenue Code and that has no income effectively connected with a United States trade or business.”<sup>9</sup> A taxpayer that meets these criteria shall not be considered to have a “substantial nexus in this state.” The Taxpayer falls within this exception, as it is a foreign corporation for federal income tax purposes and has affirmed that it has no income that is effectively connected with a United States trade or business.

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<sup>3</sup> TENN. CODE ANN. §§ 67-4-2105(a) and -2106(a) (2013 & Supp. 2019). Note that, under TENN. CODE ANN. § 67-4-2108(a)(1) (Supp. 2019), the franchise tax base “shall in no case be less than the actual value of the real or tangible property owned or used in Tennessee, excluding exempt inventory and exempt required capital investments.” According to TENN. CODE ANN. § 67-4-2108(a)(3), for purposes of this section, “property” is to be “valued at cost less accumulated depreciation in accordance with generally accepted accounting principles.”

<sup>4</sup> TENN. CODE ANN. § 67-4-2004(38) (Supp. 2019). The Taxpayer is considered a “person” because it is a corporation for federal tax purposes.

<sup>5</sup> TENN. CODE ANN. § 67-4-2004(14)(A).

<sup>6</sup> See, e.g., *Broadmoor-Kingsport Apartments, Inc. v. State*, 686 S.W.2d 70, 73 (Tenn. 1985) (holding that corporation’s holding of record title to real property and its activities with respect to the property indicated that corporation was “doing business” in Tennessee).

<sup>7</sup> TENN. CODE ANN. § 67-4-2004(49)(A).

<sup>8</sup> *Id.*

<sup>9</sup> TENN. CODE ANN. § 67-4-2004(49)(B).

Thus, the Taxpayer does not have substantial nexus with Tennessee. Although the Taxpayer is doing business in Tennessee, it lacks substantial nexus and is therefore not subject to the franchise tax on this basis.

The Taxpayer has asked whether persons who do not have substantial nexus with Tennessee may nonetheless be subject to the Tennessee franchise tax by virtue of exercising the corporate franchise.

The Tennessee General Assembly added the “exercising the corporate franchise” language to the franchise tax imposition statute in 1999 (the “1999 Act”).<sup>10</sup> The legislature did not define what constitutes “exercising the corporate franchise.” In the absence of a statutory definition, the term must be given its natural and ordinary meaning.<sup>11</sup> A common definition of the term “exercise” is to “implement the terms of.”<sup>12</sup> “Corporate franchise” is defined as the “government-conferred right or privilege to engage in a specific business or to exercise corporate powers.”<sup>13</sup> Accordingly, the plain language of the statute imposes the franchise tax on persons implementing the terms of their government-conferred privilege to exercise corporate powers. However, the statute is unclear as to whether the relevant corporate franchise must be conferred by Tennessee or whether it can be conferred by another jurisdiction. If the meaning of a statute is unclear, Tennessee courts may look to the legislative history to guide the statute’s construction.<sup>14</sup>

Prior to the 1999 Act, the franchise tax statute provided that “[a]ll corporations . . . organized for profit under the laws of this state or any other state or country *and* doing business in Tennessee” were subject to Tennessee franchise tax.<sup>15</sup> Accordingly, the franchise tax was imposed on all for-profit corporations doing business in the state, regardless of their place of incorporation.

The 1999 Act changed the franchise tax statute such that “all persons doing business in Tennessee, *or exercising the corporate franchise*” became subject to Tennessee franchise tax.<sup>16</sup> Notably, the Tennessee General Assembly removed the language addressing the corporation’s place of incorporation and at the same time added general language about exercising the corporate franchise. The legislative history of the 1999 Act indicates that the General Assembly’s intent in imposing the franchise tax on those “exercising the corporate franchise” was to broaden the franchise and excise tax base to include limited liability companies, as they were not previously liable for these taxes and entities of this kind were increasing in number. The bill’s sponsor explained that the bill would impose the franchise and excise taxes on all “limited liability companies that are granted such limited liability

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<sup>10</sup> 1999 Tenn. Pub. Acts 964 (codified as amended at TENN. CODE ANN. § 67-4-2105(a) (Supp. 2019)).

<sup>11</sup> The Tennessee Supreme Court has stated that when a statute does not define a term, it is proper to look to common usage to determine the term’s meaning. *See, e.g., Beare Co. v. Tenn. Dept. of Revenue*, 858 S.W.2d 906, 908 (Tenn. 1993).

<sup>12</sup> *Exercise*, BLACK’S LAW DICTIONARY (10th ed. 2014).

<sup>13</sup> *Franchise*, BLACK’S LAW DICTIONARY (10th ed. 2014).

<sup>14</sup> *See State v. Sherman*, 266 S.W.3d 395, 401 (Tenn. 2008). However, “the text of the statute is of primary importance, and the words must be given their natural and ordinary meaning in the context in which they appear and in light of the statute’s general purpose.” *Mills v. Fulmarque, Inc.*, 360 S.W.3d 362, 368 (Tenn. 2012).

<sup>15</sup> Tenn. Code Ann, § 67-4-903(a) (repealed 1999) (emphasis added).

<sup>16</sup> 1999 Tenn. Pub. Acts 964 (codified as amended at TENN. CODE ANN. § 67-4-2105(a) (Supp. 2019)) (emphasis added).

by Tennessee.”<sup>17</sup> The stated intent, coupled with the removal of language clearly imposing the franchise tax on corporations regardless of place of incorporation, evidences the General Assembly’s intent to include “exercising the corporate franchise” as a way to impose the franchise tax on Tennessee-chartered and Tennessee-organized business entities that confer limited liability protection on their owners.<sup>18</sup>

Furthermore, foreign corporations are permitted to transact business in Tennessee after obtaining a certificate of authority from the Tennessee Secretary of State.<sup>19</sup> This certificate of authority, however, is not equivalent to a corporate franchise. Whereas a corporate franchise grants the rights and privileges to exercise corporate powers,<sup>20</sup> a certificate of authority merely authorizes a foreign corporation to transact such business in the state.<sup>21</sup> Additionally, a certificate of authority does not permit Tennessee to regulate the foreign corporation’s organization or internal affairs as the state or country of incorporation can.<sup>22</sup> Thus, a certificate of authority is not a corporate franchise.

Moreover, Tennessee imposes the franchise tax on corporations exercising the corporate franchise in Tennessee. This necessarily requires that an entity hold a Tennessee charter or Tennessee Articles of Organization to be exercising the corporate franchise in Tennessee. Because the Taxpayer is not a Tennessee-chartered corporation, it is not exercising the corporate franchise in Tennessee by storing inventory in the state.

Accordingly, the Taxpayer is not subject to the Tennessee franchise tax.<sup>23</sup>

APPROVED:	David Gerregano Commissioner of Revenue
DATE:	10/9/2020

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<sup>17</sup> Deb. on H.B. 1676, 101st Gen. Assemb. 1999 Sess. (Tenn. May 24, 1999) (statement of Rep. Kisber, Chair, H. Comm. on Finance, Ways & Means) (emphasis added).

<sup>18</sup> TENN. CODE ANN. § 67-4-2105(a) was further amended in later years. However, these amendments only affected the portion of the statute imposing the tax on those persons doing business in Tennessee. In 2000, the statute was amended to specifically include limited liability companies doing business in Tennessee within the franchise tax base. 2000 Tenn. Pub. Acts 3200 (codified as amended at TENN. CODE ANN. § 67-4-2105(a) (Supp. 2019)). Additionally, in 2015, the statute was amended to require that persons doing business in the state also have a substantial nexus in the state to be subject to the franchise tax. 2015 Tenn. Pub. Acts. 635 (codified as amended at TENN. CODE ANN. § 67-4-2105(a) (Supp. 2019)).

<sup>19</sup> TENN. CODE ANN. § 48-25-101(a) (Supp. 2019).

<sup>20</sup> *Supra* note 9.

<sup>21</sup> TENN. CODE ANN. § 48-25-105(a); *Certificate*, BLACK’S LAW DICTIONARY (10th ed. 2014).

<sup>22</sup> TENN. CODE ANN. § 48-25-105(c).

<sup>23</sup> The Taxpayer did not request that this ruling address the Taxpayer’s liability for excise tax. Nonetheless, the Taxpayer would not be subject to Tennessee excise tax because it lacks a substantial nexus in the state.