

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 13-16**

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. 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

Application of the Tennessee business tax to management services or management consulting services.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] (the "Taxpayer") is a [REDACTED – BUSINESS ENTITY TYPE] engaged in the business of providing [MANAGEMENT CONSULTING] services to [HEALTH CARE INDUSTRY] facilities (the "Clients"). The Taxpayer currently provides services to [NUMBER OF] Clients in Tennessee. The Taxpayer holds no ownership interest in any Client or in any other entity. The Taxpayer's [REDACTED] is the sole shareholder of [BUSINESS ENTITY], the entity that wholly owns the Taxpayer. The Taxpayer's [SOLE SHAREHOLDER] also owns an interest in [NUMBER OF] Clients that the Taxpayer currently serves, as indicated below:

[TABLE REDACTED].

The Taxpayer provides [MANAGEMENT CONSULTING] services for its Clients, either by performing the service directly or by assisting its Clients in performing the function. The Taxpayer's [MANAGEMENT CONSULTING] services include:

- 1) Procurement, negotiation, and administration of contracts between the Client and third party vendors;
- 2) Oversight of maintenance and repair of the [HEALTH CARE INDUSTRY] facility building and grounds;
- 3) Billing and collection of accounts receivable;
- 4) Processing of accounts payable;
- 5) Preparation of financial statements and other financial reports;
- 6) Maintenance of records, books, and accounts;
- 7) Legal assistance and oversight of attorneys retained for the benefit of the Clients;
- 8) Procurement of insurance for the benefit of the Clients;
- 9) Administration and monitoring of Clients' insurance claims;
- 10) Guidance on the Clients' legal and regulatory compliance efforts and programs;
- 11) Development of and advice regarding quality assurance matters and the creation of policies and procedures with respect thereto;
- 12) Human resource services including payroll administration, employee recruitment and retention, and legal and regulatory compliance;
- 13) Preparation and audit support of tax returns and cost reports;
- 14) Review of and advice regarding operating budgets;
- 15) Marketing, public relations, and communications services; and
- 16) Assistance in any other areas, as requested by the Clients.

The Taxpayer employs an accounting staff, operations consulting staff (including licensed administrators and [HEALTH CARE PROFESSIONALS]), human resources staff, legal and risk management staff (including licensed attorneys), plant maintenance consulting staff,

customer relations and marketing staff, billing and collections staff, workplace safety staff, third-party contracts administration staff, and office services staff. On rare occasion, and only at the request of a Client, [HEALTH CARE PROFESSIONALS] and licensed administrators on the Taxpayer's staff serve as interim directors of [HEALTH CARE FIELD] or administrators during an unanticipated vacancy at that Client's facility. All of the Taxpayer's agreements with its Clients specifically provide that the Taxpayer, as a consultant, does not provide any services directly to the patients/residents of the [HEALTH CARE INDUSTRY] facilities.

The Taxpayer uses two billing methods. The first method is a shared cost center allocation whereby Clients pay their pro rata share of the Taxpayer's costs incurred, based on patient days, with no add-on of profit. The shared cost center allocation method applies to billing (accounts receivable) and disbursements (accounts payable), human resources, risk management, workers' compensation/workplace safety, legal, [HEALTH CARE PROFESSIONALS] consultants (quality assurance), customer and community relations (marketing), and plant maintenance consulting personnel ("Services Billed as Cost Center Allocations"). The shared cost center allocations are the larger portion of payments the Taxpayer receives for its services.

The Taxpayer bills its Clients for services falling outside cost center allocations as a management consulting fee ("Services Billed as a Management Consulting Fee"). This fee may include a profit margin associated with the particular services.

RULINGS

1. Is the Taxpayer subject to the Tennessee business tax?

Ruling: Yes. The Taxpayer is subject to the Tennessee business tax under Classification 3, as a provider of management services or management consulting services.

2. If the Taxpayer is subject to the Tennessee business tax, to what extent are receipts from the services that the Taxpayer provides taxable?

Ruling: All of the Taxpayer's gross receipts from the services that it performs are subject to the Tennessee business tax.

ANALYSIS

The Tennessee Business Tax Act¹ is one component of Tennessee's broader privilege and excise taxation statutes. The Act imposes, in certain instances, a tax on the privilege of making sales by engaging in any business activity described in TENN. CODE ANN. § 67-4-708(1)-(4) (2013).

The Act was modified in several respects by the Uniformity and Small Business Relief Act of 2013,² which is effective for tax periods beginning on or after January 1, 2014.³ This ruling will

¹ Tennessee Business Tax Act, ch. 387, §§ 1-27, 1971 Tenn. Pub. Acts 994, 994-1019 (codified as amended at TENN. CODE ANN. § 67-4-701 to -730 (2013)).

address the issues by applying the law as it exists as of the issuance date of this letter ruling, but if the analysis would change under the provisions of the Uniformity and Small Business Relief Act of 2013, then the ruling will address the analysis under the Uniformity and Small Business Relief Act of 2013 as well.⁴

1. Application of the Business Tax

The Taxpayer is subject to the Tennessee business tax under Classification 3, as a provider of management services or management consulting services.

A taxpayer is classified under TENN. CODE ANN. § 67-4-708 according to its “dominant business activity,” and this classification determines the rate of the business tax.⁵ The term “dominant business activity” is defined for business tax purposes under TENN. CODE ANN. § 67-4-702(a)(5) (2013) as “the business activity that is the major and principal source of taxable gross sales of the business.” The Department has issued guidance interpreting “dominant business activity” to mean “[t]he item comprising the largest proportion of gross sales of the business when compared with other items sold.”⁶

“Persons”⁷ whose dominant business activity is “making sales of services or engaging in the business of furnishing or rendering services” are included in Classification 3.⁸

However, TENN. CODE ANN. § 67-4-708(3)(C)(i)-(xvi) excepts services rendered by sixteen industry groups from the Tennessee business tax.⁹ TENN. CODE ANN. § 67-4-708(3)(C) states that

² Uniformity and Small Business Relief Act of 2013, ch. 313, §§ 1-23, 2013 Tenn. Pub. Acts __, __ (codified in various sections of Part 7 of Chapter 4 of Title 67).

³ *Id.* at § 23.

⁴ More information about the Uniformity and Small Business Relief Act of 2013 may be found on the Department’s website, available at <http://tn.gov/revenue/legsumm/2013legsumm.shtml#bizpc313> (last visited Oct. 23, 2013).

⁵ TENN. CODE ANN. § 67-4-709 (2013).

⁶ TENN. COMP. R. & REGS. 1320-4-5-.15 (1974). When a business engages in taxable activities enumerated in TENN. CODE ANN. § 67-4-708(1)-(4) (2013), yet the item comprising the largest proportion of gross sales does not fall within any of those classifications, the business is not exempt. *Hermitage Memorial Gardens Mausoleum & Memorial Chapel v. Dunn*, 541 S.W.2d 147 (Tenn. 1976). Applying a previous version of the Tennessee Business Tax Act, the Tennessee Supreme Court ruled that “[a]ll entities who make sales by engaging in any of the business activities enumerated in § 67-5805 [now codified, as amended, at TENN. CODE ANN. § 67-4-708 (2013)] are subject to the tax,” and that “[t]he dominant business activity of a taxpayer is relevant only in determining which of the classifications in § 67-5805 applies to him.” *Id.* at 149.

⁷ “Person” is broadly 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.” TENN. CODE ANN. § 67-4-702(a)(12).

⁸ TENN. CODE ANN. § 67-4-708(3)(C) (2013).

⁹ TENN. CODE ANN. § 67-4-708(3)(C).

“[i]t is the legislative intent that the exceptions ... shall include the sales of services by those businesses or establishments so described in the Standard Industrial Classification Index of 1972, including all supplements and amendments [thereto].” The most recent version of the index is the Standard Industrial Classification Manual of 1987 [hereinafter SIC Manual of 1987].¹⁰

In the unreported case of *Aabakus, Inc. v. Huddleston*,¹¹ the Tennessee Court of Appeals considered the applicability of the business tax exceptions as set forth in TENN. CODE ANN. § 67-4-708(3)(C)(i)-(xvi) to a business that provided human resources management services¹² and described itself as a “rentable human resources department.”¹³ In that case, the taxpayer argued that it was exempt from the business tax because as part of its human resources management services, it was providing accounting, auditing, and bookkeeping services exempt from taxation under TENN. CODE ANN. § 67-4-708(3)(C)(viii).¹⁴ The Tennessee Court of Appeals found that the taxpayer’s “dominant business activity [was] much more than mere accounting, auditing, and bookkeeping services”¹⁵ and stated that the accounting, auditing, and bookkeeping services were “not separate activities generating a separate share of the ‘value added’ . . . but rather [were] part-and-parcel of the entire service package performed.”¹⁶ Accordingly, the court concluded that the business’s function was broader than a single industry and that it should be classified under a miscellaneous industry category such as management consulting under SIC Industry number 8742.¹⁷ The court subsequently held that “as a matter of law, [the taxpayer] is not entitled to a complete exemption from business taxes under TENN. CODE ANN. § 67-4-708(3)(C)(viii).”¹⁸

In providing management consulting services, the Taxpayer here is exercising the taxable privilege of making sales by engaging in a business activity described in TENN. CODE ANN. § 67-

¹⁰ In 1997, the Office of Management and Budget decided to replace the Standard Industrial Classification Manual with a new system, the North American Industry Classification System, in response to “[r]apid changes in both the U.S. and world economies [that] brought the SIC under increasing criticism.” OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, NORTH AMERICAN INDUSTRY CLASSIFICATION SYSTEM 13 (2007). Because the statute refers only to the SIC and the amendments to it, the SIC Manual of 1987 remains applicable under TENN. CODE ANN. § 67-4-708(3)(C).

¹¹ No. 01A-01-9505-CH-00215, 1996 WL 548148, at *2 (Tenn. Ct. App. Sept. 25, 1996).

¹² The human resources services provided by the taxpayer in *Aabakus* included “(1) payroll processing and administration, (2) payment of employment-related taxes, (3) filing annual reports, (4) coordinating COBRA compliance and group medical insurance coverage, (5) coordinating worker’s compensation coverage, (6) developing and coordinating an employee policy manual, and (7) providing guidance and assistance with respect to administrative hearings, appeals, and labor disputes.” *Aabakus*, 1996 WL 548148, at *1, fn 1.

¹³ *Id.* at *1, *4.

¹⁴ *Id.* at *1.

¹⁵ *Id.*

¹⁶ *Id.* at *5.

¹⁷ *Id.*

¹⁸ *Aabakus*, 1996 WL 548148, at *5.

4-708. Like the taxpayer in *Aabakus*, the Taxpayer provides a package of management consulting services made up of a variety of different services that it does not sell individually. Rather like the management services in *Aabakus*, the functions performed by the Taxpayer are part-and-parcel of the entire service. Consequently, the Taxpayer's function also is broader than a single industry, and it is properly characterized "under one of the miscellaneous industry categories" rather than as a provider of any excepted services.¹⁹ The Taxpayer's activities could properly be classified under the miscellaneous industry categories as management services (Industry Group 8741 of the SIC Manual of 1987)²⁰ or management consulting services (Industry Group 8742 of the SIC Manual of 1987).²¹ Businesses involved in management consulting services are subject to the business tax,²² but the application of the business tax to management services businesses is more nuanced.

Industry Group 8741 of the SIC Manual of 1987 generally includes the provision of management services but adds that the "management and operation of a business, where operating staff as well as management is provided, is classified according to the activity of the establishment managed."²³ The Taxpayer's Clients are [HEALTH CARE INDUSTRY] facilities whose activities include providing [HEALTH CARE] services to individuals. Further, TENN. CODE ANN § 67-4-708(3)(C)(i) excludes from Classification 3 "medical, dental, and allied health services to human beings, including sanatorium, convalescent and rest home care" as described in the SIC Manual of 1987.

¹⁹ *Cf. Id.*

²⁰ Management services include

[e]stablishments primarily engaged in furnishing general or specialized management services on a day to day basis and on a contract or fee basis. Establishments in this industry do not provide operating staff. Management and operation of a business, where operating staff as well as management is provided, is classified according to the activity of the establishment managed.

OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 403 (1987).

²¹ Management consulting services include

[e]stablishments primarily engaged in furnishing operating counsel and assistance to managements of private, nonprofit, and public organizations. These establishments generally perform a variety of activities, such as strategic and organizational planning; financial planning and budgeting; marketing objectives and policies; information systems planning, evaluation and selection; human resource policies and practices planning; and production scheduling and control planning.

OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 403 (1987).

²² *Cf. Aabakus*, 1996 WL 548148, at *5 (concluding that *Aabakus*, a business subject to the business tax, most closely fit within SIC Industry Group 8742 as a provider of management consulting services).

²³ OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 403 (1987).

Nevertheless, the Taxpayer cannot be classified according to the activities of its Clients, [HEALTH CARE INDUSTRY] facilities. First, the Taxpayer neither owns the [HEALTH CARE INDUSTRY] facilities nor provides any services directly to the patients or residents of those facilities. Moreover, the Taxpayer's agreements with Clients specifically state that the Taxpayer, as a consultant, does not provide any services directly to the patients or residents of the [HEALTH CARE INDUSTRY] facilities. Although the [HEALTH CARE PROFESSIONALS] and administrators on the Taxpayer's staff on rare occasions serve as interim directors of [HEALTH CARE FIELD] or administrators for a Client during an unanticipated vacancy, they do not provide direct patient care. The Taxpayer provides management services and management consulting services, and its Clients utilize their own [HEALTH CARE PROFESSIONALS]. Accordingly, the Taxpayer does not provide the requisite "operating staff" to the [HEALTH CARE INDUSTRY] facilities and cannot be classified as exempt from Classification 3 according to the activity of its Clients.

Because no exemption exists under TENN. CODE ANN. § 67-4-708(3)(C)(i)-(xvi) for management services or management consulting services, the Taxpayer is not entitled to claim an exemption from the business tax. Therefore, the Taxpayer is subject to the business tax under Classification 3.

2. Extent Services are Taxable

The Taxpayer is subject to the Tennessee business tax on the receipts from all of the services that it performs.

Persons whose dominant business activity is "making sales of services or engaging in the business of furnishing or rendering services" are included in Classification 3 and subject to the business tax.²⁴ For purposes of the business tax, "services" are defined as "every activity, function or work engaged in by a person for profit or monetary gain" unless otherwise provided.²⁵ Services for profit or monetary gain, however, exclude "services rendered by a person for an affiliated business entity; provided that the services are accounted for as allocations of cost incurred in providing the services without any markup whatsoever."²⁶ Additionally, TENN. CODE ANN. § 67-4-702(18) states that "[s]ales price' for services rendered by a person for an affiliated business entity does not include any amount that is accounted for as a reasonable allocation of cost incurred in providing the service." Thus, to the extent that a taxpayer provides services for an affiliated business entity and the taxpayer accounts for those services as allocations of cost incurred in providing the services without profit markup, receipts from those services are excluded from gross receipts for purposes of calculating the business tax. If a charge to an affiliated business entity exceeds the taxpayer's cost incurred in providing the service, the amount of that charge in excess of cost, *i.e.*, the markup, is included in the sales price.

²⁴ TENN. CODE ANN. § 67-4-708(3)(C).

²⁵ TENN. CODE ANN. § 67-4-702(a)(20).

²⁶ *Id.*

An affiliated entity, generally speaking, is (1) an entity in which the taxpayer has more than a 50% ownership interest, (2) an entity that has more than a 50% ownership interest in the taxpayer, or (3) an entity in which a second entity has more than a 50% ownership interest if the second entity also has more than a 50% ownership interest in the taxpayer.²⁷

According to the facts as presented, the Taxpayer does not provide services for any affiliated business entity.²⁸ No Client has an ownership interest in the Taxpayer, and the Taxpayer has no ownership interest in any Client or any other entity. Moreover, although the Taxpayer's [SOLE SHAREHOLDER] is the only owner of the entity that wholly owns the Taxpayer and the Taxpayer's [SOLE SHAREHOLDER] has a greater than fifty percent (50%) ownership interest in [NUMBER OF] Clients that the Taxpayer serves, that common ownership does not establish an affiliation among business entities for purposes of the business tax.²⁹

Thus, all of the Taxpayer's gross receipts are included in the calculation of its business tax liability.³⁰

Jennifer Wilson
Assistant General Counsel

APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: November 19, 2013

²⁷ See TENN. CODE ANN. § 67-4-702(a)(1).

²⁸ [REDACTED].

²⁹ If the entity that owns the Taxpayer also had a greater than fifty percent (50%) ownership interest in a Client, the Taxpayer and that Client would be affiliated business entities for purposes of the business tax.

³⁰ Note that, if in the future the Taxpayer provides services to an entity that is properly considered an affiliated business entity for purposes of the business tax, its Services Billed as Cost Center Allocations rendered to such entity are excluded from gross receipts for purposes of calculating the business tax because they are billed as shared cost center allocations whereby Clients pay the Taxpayer their pro rata share of the Taxpayer's costs incurred, based upon patient days, with no added profit margin. But with regard to the Taxpayer's Services Billed as a Management Consulting Fee, only charges to an affiliated business entity in excess of the Taxpayer's costs incurred would be included in the sales price and subject to the business tax.