TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-18

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Whether [TAXPAYER] has substantial tax nexus in states other than Tennessee so as to be entitled to use an apportionment formula in computing its Tennessee franchise, excise tax liability?

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 his detriment.

FACTS

[TAXPAYER] is a Tennessee corporation with its principal place of business located in Tennessee. [TAXPAYER] is a corporate affiliate of [CORPORATION], which is a Delaware corporation with its principal place of business also located in Tennessee. The business of [TAXPAYER] is purchasing accounts receivable created when [CORPORATION] sells products to customers throughout the United States.

Once a [CORPORATION] customer creates an account receivable, [TAXPAYER] purchases the account and uses its employees to manage and collect it. Employees of [CORPORATION] are also used by [TAXPAYER] to assist in the management of relationships with customers in states other than Tennessee. [CORPORATION] employees systematically contact [TAXPAYER] debtors in person in various states in order to ensure collection of [TAXPAYER] accounts, to discuss credit issues and to go over the status of [TAXPAYER] customer accounts.

The relationship between [TAXPAYER] and [CORPORATION] is very close. A [CORPORATION EMPLOYEE] is responsible for overseeing all domestic accounts receivable of [TAXPAYER]. This [CORPORATION EMPLOYEE] also supervises [TAXPAYER] employees. [TAXPAYER] contacts customers in other states on a continuous basis to discuss payment and other related issues. Additionally, [TAXPAYER] directs salespeople for its corporate affiliate, [CORPORATION], to personally visit with customers in certain states, such as [STATES – NOT TENNESSEE]. These visits are for the benefit of [TAXPAYER], and the salesmen typically discuss credit issues, collection issues, and account status issues with customers at their offices. These face-to-face meetings with customers are crucial to [TAXPAYER'S] ability to establish and maintain a market in the states where the meetings occur.

When face-to-face meetings between [TAXPAYER] customers and [CORPORATION] employees, acting on behalf of [TAXPAYER], fail to resolve collection issues, [TAXPAYER] retains collection agents in other states to resolve those issues and collect delinquent accounts. [TAXPAYER] will make telephone calls and send four letters to a customer in another state before referring the account to a private collection agency.

[TAXPAYER] pays Tennessee franchise, excise taxes. It also pays income-based taxes in [STATES – NOT TENNESSEE] on a separate basis. [STATE – NOT TENNESSEE] taxes any financial institution that "regularly engages in transactions with customers in [STATE – NOT TENNESSEE] that involved intangible property, including loans . . . and result in receipts flowing to the taxpayer from within [STATE – NOT TENNESSEE]." [STATE – NOT TENNESSEE] Code Ann. § ---. [STATE – NOT TENNESSEE] similarly taxes all foreign corporations "regularly engaging in transactions with customers in the

commonwealth that involve intangible property and result in income flowing to the taxpayer from residents of the commonwealth." [STATE – NOT TENNESSEE] Ann. Laws Ch. [-- § --]. [TAXPAYER] has millions of dollars in receipts flowing to it from [STATES – NOT TENNESSEE] residents. [TAXPAYER] also pays income based taxes as member of [CORPORATION'S] unitary group in [STATES – NOT TENNESSEE]. Because it pays such taxes in multiple states other than Tennessee, [TAXPAYER] apportions its Tennessee franchise, excise tax liability.

QUESTION PRESENTED

Does [TAXPAYER] have substantial tax nexus in states other than Tennessee so as to be entitled to use an apportionment formula in computing its Tennessee franchise, excise tax liability?

RULING

Yes.

ANALYSIS

Tenn. Code Ann. §§ 67-4-2010 and 67-4-2110 make the following provisions concerning a taxpayer's right to use an apportionment formula in computing its Tennessee franchise, excise tax liability:

> (a) Any taxpayer having business activities that are taxable both inside and outside the state of Tennessee shall allocate or apportion its net earnings or losses [net worth] as provided in this part.
>
> (b) For purposes of allocation and apportionment of net earnings or losses [net worth] under this part, a taxpayer is taxable in another state if:
>
> > (1) In that state it is subject to a net income tax, a franchise tax measured by net income , a franchise tax for the privilege of doing business, or a corporate stock tax; or
> >
> > (2) That state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.
>
> (b) Nonbusiness receipts shall not be included in the numerator or denominator of any apportionment formula.

The statutes clearly state that a taxpayer that is "subject to" an income based tax in another state is entitled to use an apportionment formula in computing its Tennessee franchise, excise tax liability. In order to be subject to an income based tax in a state other than Tennessee, a business entity must be doing

business in that state so as to have substantial tax nexus there. The payment of an income based tax to a state in which a taxpayer does not have substantial tax nexus does not result in the taxpayer being "subject to" an income based tax in that state. *Howard Cotton Company v. Olsen,* 675 S.W.2d 154 at 164 (Tenn. 1984) citing *Signal Thread Co. v. King,* 435 S.W.2d 468 (Tenn. 1968).

The determination of whether [TAXPAYER] has the requisite substantial tax nexus in a state other than Tennessee must be made in the light of the United States Constitution's limitations on the taxing power of the states.

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 [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.*

If contacts are sufficient to subject an entity to personal jurisdiction in the forum state, then imposition of a tax on the entity's business in the state will be sustained under the Due Process Clause. So long as a commercial actor's efforts are purposefully directed toward residents of a state, even the absence of physical contacts cannot defeat the personal jurisdiction of such state under the Due Process Clause. *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, at 476 (1987).

[TAXPAYER] has purposefully directed its efforts toward the residents of states other than Tennessee by purchasing accounts receivable due to [CORPORATION] from its customers in states other than Tennessee and by using its employees to manage and collect such receivables.

Under the facts presented, it appears that subjection of [TAXPAYER] to income based taxes in states where it is responsible for collecting accounts receivable purchased from [CORPORATION] would not violate the requirements of the Due Process Clause of the U.S. Constitution. But, in order for such states to subject [TAXPAYER] to income based taxation, the requirements of the Commerce Clause of the United States Constitution must also be met.

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. *Quill Corporation v. North Dakota,* 504 U.S. 298, at 309 (1992). This implicit limitation on the power of states to interfere with interstate commerce is known as the "negative" or "dormant" Commerce Clause. *Id.*

Dormant Commerce Clause jurisprudence in the area of state taxation changed dramatically with the U.S. Supreme Court's decision in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). The *Complete Auto* decision rejected the line of cases that held impermissible the direct taxation of interstate commerce by the states and enunciated a four-part test providing that imposition of a tax will be sustained so long as the tax meets all of the following criteria:

1. The tax must be applied to an activity with a substantial nexus in the taxing state.

2. The tax must be fairly apportioned.

3. The tax must not discriminate against interstate commerce.

4. The tax must be fairly related to the services provided by the taxing state.

The substantial nexus test in the first prong of the *Complete Auto* decision is critical in determining whether [TAXPAYER] can be subjected to an income based tax in states where its debtors reside.

In *J.C. Penney,* 19 S.W.3d 831 (Tenn.Ct.App. 1999) *appeal denied,* (Tenn. May 8, 2000), *cert. denied, Johnson v. J.C. Penney National Bank,* 531 U.S. 927 (2000)., the Tennessee Court of Appeals was presented with an opportunity to consider whether J.C. Penney National Bank had the requisite substantial Tennessee nexus to be subjected to franchise, excise taxes. J.C. Penney National Bank had no physical presence of consequence in Tennessee, but was making credit card loans to customers in Tennessee.

The Tennessee Court of Appeals refused to uphold the Department's imposition of franchise, excise taxes on J.C. Penney National Bank. The Court reached this decision because, other than credit cards issued to its customers, which the Court held were "in and of themselves virtually worthless," J.C. Penney National Bank had no Tennessee physical presence and thus did not have the requisite "substantial nexus" in Tennessee to satisfy the first prong of the *Complete Auto* test.

In *America Online, Inc. v. Johnson,* WL 1751434 at 2 (Tenn.Ct.App. 2002), the Tennessee Court of Appeals observes that the U.S. Supreme Court has rejected state taxes on interstate commerce where no activities are carried on in the

taxing state on the taxpayer's behalf. Citing *Tyler Pipe Industries v. Washington,* 483 U.S. 232 (1987) and *Scripto v. Carson,* 362 U.S. 207 (1960), the Court further comments that "[i]n other cases where the out-of-state taxpayer did not actually have offices or employees in the taxing state, the [U.S. Supreme Court], nevertheless, found a substantial nexus based on in-state activities carried on by affiliates or independent contractors on the taxpayer's behalf." *Id.* at 2. In any case, "[t]he activity taxed must have substantial nexus with the state." *Id.* at 2.

"We know that a substantial nexus may be established by activities carried on within the state by affiliates and independent contractors." *Id.* at 3. "Where . . . activities are 'being conducted in the taxing state that substantially contribute to the taxpayer's ability to maintain operations in the taxing state,' a substantial nexus does exist." *Id.* at 3, citing *J.C. Penney*, 19 S.W.2d at 841 (referencing *Tyler Pipe,* 483 U.S. 232 and *Scripto,* 362 U.S. 207). "The crucial factor governing nexus is whether the activities performed in [the] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state. . ." *Tyler Pipe,* 483 U.S. 232 at 250.

Substantial collection activities conducted in another state by a Tennessee business entity, or on its behalf by an affiliate or an independent contractor, would contribute to the entity's ability to maintain operations in the state and would result in the entity having the requisite substantial nexus to be subjected to an income based tax.

The facts presented state that [TAXPAYER] uses employees of [CORPORATION] to assist in the management of relationships with customers in states other than Tennessee. A [CORPORATION EMPLOYEE] is responsible for overseeing all domestic accounts receivable of [TAXPAYER]. [CORPORATION EMPLOYEE] also supervises [TAXPAYER] employees. [TAXPAYER] contacts customers in other states by letter and by telephone on a continuous basis to discuss payment and other related issues. Additionally, [TAXPAYER] directs salespeople for its corporate affiliate, [CORPORATION], to personally visit with customers in certain states, such as [STATES – NOT TENNESSEE].

These visits are for the benefit of [TAXPAYER], and the salesmen typically discuss credit issues, collection issues, and account status issues with customers at their offices. Face-to-face meetings with customers are crucial to [TAXPAYER'S] ability to establish and maintain a market in the states where the meetings occur. Obviously, [TAXPAYER] cannot continue its business of purchasing accounts receivable from [CORPORATION] if the accounts purchased are not collected. When face-to-face meetings between [TAXPAYER] customers and [CORPORATION] employees, acting on behalf of [TAXPAYER], fail to resolve collection issues, [TAXPAYER] retains collection agents in other states to resolve those issues and collect delinquent accounts.

The facts presented clearly establish that [TAXPAYER] is doing business in [STATES – NOT TENNESSEE] and paying an income based tax in those states because it has substantial tax nexus in each state. It has physical presence in both these states through employees of [CORPORATION] who, on behalf of [TAXPAYER], personally visit with customers to discuss and resolve credit related matters and collection issues. As a result, [TAXPAYER] is entitled to use an apportionment in computing its Tennessee franchise, excise tax liabilities.

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APPROVED: Loren L. Chumley, Commissioner

DATE: 5/15/06