

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 02-07**

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

Application of sales and use tax to leases of motor vehicles no longer used in Tennessee.

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

[THE TAXPAYER] is headquartered in [CITY NOT IN TENNESSEE]. It leases motor vehicles to customers in Tennessee from its [NUMBER] Tennessee branch offices. On [DATE], 2000, one of the Taxpayer's Tennessee branch offices entered into a true lease of a motor vehicle for more than one year with a Tennessee customer. Subsequently, the Taxpayer collected and remitted Tennessee sales tax on the lease payments it received. On [DATE], 2001, the Tennessee lessee of the motor vehicle relocated to Illinois. When the leased vehicle was registered in Illinois, the Taxpayer was required to pay use tax to the State of Illinois based upon the purchase price of the vehicle, less depreciation¹. The Taxpayer states Illinois gave credit for the Tennessee sales taxes already paid on the lease.

ISSUES

1. Under the Tennessee sales tax statutes, does the sales tax apply to the remaining lease payments after the lessee has relocated and removed the leased vehicle to another state?
2. If so, does this application of the tax constitute a violation of the Commerce or Due Process Clauses of the United States Constitution?

RULINGS

1. Yes.
2. No.

ANALYSIS

The Tennessee sales tax applies to leases of tangible personal property through the application of several statutes. Tenn. Code Ann. § 67-6-204(a) provides in part:

It is declared to be the intention of this chapter to impose a tax on the gross proceeds of all leases and rentals of tangible personal property in this state where the lease or rental is a part of the regularly established business, or the same is incidental or germane thereto.

¹ The written ruling request stated: "The basis of the (Illinois) tax was the amount of the remaining lease payments." However, on January 4, 2002, [TAXPAYER'S ACCOUNTANT] indicated by phone that the Illinois tax was actually on the cost of the vehicle, less depreciation.

Tenn. Code Ann. § 67-6-201 provides in part:

It is declared to be the legislative intent that every person is exercising a taxable privilege who:

...
(6) Leases or rents such property, either as lessor or lessee, within the state of Tennessee;

"Lease or rental" means the leasing or renting of tangible personal property and the possession or use thereof by the lessee or renter for a consideration, without transfer of the title of such property. Tenn. Code Ann. § 67-6-102(16). A lease or rental in Tennessee constitutes a sale.

"Sale" means any transfer of title or possession, ... lease or rental, ... of tangible personal property for a consideration

Tenn. Code Ann. § 67-6-102(25)(A).

Under the facts presented, the lease takes place in Tennessee for sales tax purposes. The lease agreements are executed in Tennessee, but this is not the Tennessee event that triggers the tax. Instead, it is the delivery of the leased property to the lessee in Tennessee that is the discrete taxable transaction for sales tax purposes. The fact that the tangible personal property being leased is to be used out-of-state does not affect the application of the tax. The Department's Rules explain this as follows:

The terms of the contract under which such tangible personal property is leased or rented shall be the basis for computing the tax. The tax is to be computed on a billing basis, either on the lump sum at the time of execution, or on a monthly or periodical basis as provided in the contract. The Sales Tax shall apply to all leases of tangible personal property delivered to a lessee or rentee in this State, *regardless of where the property will be taken or used by the lessee or rentee*, whether within or without the State of Tennessee.

TENN. COMP. R. & REGS. 1320-5-1-.32(2) (Emphasis mine). Accordingly, the sales tax is due on all lease payments if the leased property is delivered in Tennessee.

In *Williams Rentals, Inc. v. Tidwell*, 516 S.W.2d 614 (Tenn. 1974) the Tennessee Supreme Court upheld the imposition of the sales tax on leases of equipment delivered in Tennessee for use solely outside the State of Tennessee. Williams argued the lease should not be taxed under the sales tax statute since the equipment was not used in Tennessee, and application of the tax would result in unconstitutional double taxation. In its ruling, the Court relied upon its earlier decision in *Central Transportation Co. v. Atkins*, (305 S.W.2d 940) (1956) wherein the Court stated:

... the able argument is made, "that a lease or rental of tangible personal property

does not create a taxable transaction in Tennessee unless the leased property is used and consumed in Tennessee, * * *.” As we see it and under the decisions of the Supreme Court of the United States this though is not the test. The test is where the lease was made upon which the tax is based. The tax is based upon the making of the lease in Tennessee. It is not upon what was going to be done under the lease because that is a thing that the parties could work out among themselves.

Williams Rentals, Inc. v. Tidwell, 516 S.W.2d at 616, quoting *Central Transportation Co. v. Atkins*, (305 S.W.2d at 942, 943). The *Williams* Court also cited a number of United States Supreme Court decisions that were controlling at that time, and concluded the application of the sales tax to leases of equipment delivered in Tennessee did not violate the Commerce Clause.

The *Williams Rentals* decision of the Tennessee Supreme Court was prior to the United States Supreme Court’s landmark decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977). *Complete Auto* opened the door to state taxation of interstate commerce. It also established the very important four-prong test of constitutionality.² While the Tennessee Court did not rely upon the four-prong test in *Williams Rentals*, it did apply *Complete Auto* in the case of *Itel Containers International Corp. v. Cardwell*, 814 S.W. 2d 29,31 (Tenn. 1991), affirmed sub nom. *Itel Containers International Corp. v. Huddleston*, 507 U.S. 60, 113 S. Ct. 1095, 122 L. Ed. 421 (1993).³

In *Itel Container International Corp. v. Cardwell*, 814 S.W.2d. 29 (Tenn. 1991), the Tennessee Court considered the application of the Tennessee sales tax to the lease of cargo containers delivered in Tennessee for use in international shipments. Itel first argued that the mere transfer of possession of leased property in Tennessee was not a sales taxable event. The Court made short work of this argument. The Court concluded the legislature clearly intended to apply the sales tax to leased property delivered in Tennessee even though the lease agreements were executed outside Tennessee. *Id.* p. 31. Itel further contended the tax violated the Commerce and Due Process Clauses.

The Court held the Tennessee sales tax on leases met the four-fold Commerce Clause requirements of *Complete Auto*. *Id.* p. 36. The Court said:

We are persuaded that Itel's containers have a "substantial nexus" with Tennessee, since they are present within the state at the time of transfer of possession to each lessee, and since the containers are in the custody of Itel's employees and agents in Tennessee. Moreover, the tax is "fairly apportioned," since it is levied only on the proceeds of leases pursuant to which the lessee takes delivery in Tennessee. The tax does not "discriminate," since it falls even-handedly on all leased personal property in the state; and finally, the tax is "fairly related to the services provided by [Tennessee], services that include not only police and fire protection, but also the benefit of a

² The Taxpayer believes the Tennessee sales tax on leases of tangible personal property removed to other states does not pass this four-prong test.

³ On Appeal to the United States Supreme Court, the Taxpayer did not dispute the decision of the State Court on the domestic Commerce Clause.

trained work force and the advantages of a civilized society."

Id. p. 35. The Court determined the Tennessee's tax was imposed upon the "discrete transaction" of the transfer of possession of leased cargo containers in Tennessee. *Id.* p. 37. In a footnote, the Court further held the Due Process Clause requirements were also satisfied by the Tennessee statute. *Id.* p. 36 n.7. Under modern case law, when the more stringent nexus requirements of the Commerce Clause are satisfied, the Due Process nexus requirements are also met.

The Taxpayer ruling request also specifically raises the issue of whether the sales tax on leases in Tennessee is externally and internally consistent under the Commerce and Due Process Clauses. The Tennessee Court decisions previously cited implicitly ruled the Tennessee sales tax on leases was internally and externally by upholding the statute. However, for an in depth discussion of this specific issue as applied to sales taxes it is necessary to turn to one more case.

In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 115 S.Ct.1331 (1995), the United States Supreme Court considered the application of a sales tax on bus tickets sold in Oklahoma for interstate travel originating in Oklahoma. Oklahoma took the position the bus ticket sale was a wholly local transaction justifying the state's sales tax on the ticket's full value. The Court upheld the tax, but gave special attention to the application of the second prong of the Commerce Clause test to the "discrete" sales tax transaction. The purpose of the second prong of *Complete Auto* 's test is to ensure that each State taxes only its fair share of an interstate transaction. The Court discussed internal and external consistency required for a sales tax to meet the requirements of the second prong:

Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear.... There is no failure [of internal consistency] in this case, however. If every State were to impose a tax identical to Oklahoma's, that is, a tax on ticket sales within the State for travel originating there, no sale would be subject to more than one State's tax.

External consistency, on the other hand, looks not to the logical consequences of cloning, but to the economic justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State. See *Goldberg*, supra, 488 U.S., at 262, 109 S.Ct., at 589; *Container Corp.*, supra, 463 U.S., at 169-170, 103 S.Ct., at 2942- 2943. Here, the threat of real multiple taxation (though not by literally identical statutes) may indicate a State's impermissible overreaching.

Id. at 185, 115 S.Ct. at 1338. After reviewing the application of external consistency to the frequent apportionment disputes involving income taxes, the Court turned to the unique application of external consistency to sales taxes that are applied to discrete events:

In reviewing sales taxes for fair share, however, we have had to set a different course. A sale of goods is most readily viewed as a *discrete event* facilitated by the laws and amenities of the place of sale, and the transaction itself does not readily reveal the extent to which completed or anticipated interstate activity affects the value on which a buyer is taxed. We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future.... [W]e found a sufficient safeguard against the risk of impermissible multiple taxation of a sale in the fact that it was consummated in only one State.

...

In light of this settled treatment of taxes on sales of goods and other successive taxes related through the stream of commerce, it is fair to say that because the taxable event of the consummated sale of goods has been found to be properly treated as unique, an internally consistent, conventional sales tax has long been held to be externally consistent as well.

Id. at 186-188, 115 S.Ct. at 1339-1340 (Emphasis mine).

In this instant case, the discrete event is the delivery of a leased automobile in Tennessee. Under the Tennessee law, this discrete event is taxable in Tennessee. If all other states taxed this unique transaction in the same way there would be no multiple tax burden. Therefore, the Tennessee sales tax on leases is both internally and externally consistent. Additionally, both Tennessee and Illinois allow credit against the compensating use tax for sales taxes paid to other states on the same transaction. *See*: Tenn. Code Ann. § 67-6-507(a) & ILL. ANN. STAT. ch. 35 § 105/3-55(d). In this case, the Illinois tax is upon the purchase of the vehicle while the Tennessee tax is upon the lease of the vehicle. The same transaction is not being taxed by both states.⁴

Charles Moore
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APPROVED: Ruth E. Johnson
Commissioner of Revenue

DATE: March 18, 2002

⁴ The Illinois credit provision designed to prevent the unconstitutional multistate taxation of the same unique event may not be applicable in this case.