

TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 13-20

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

The application of Tennessee's sales, use, and business taxes to certain activities within foreign trade zones.

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 located in a foreign trade zone in Tennessee and operates as a contractor providing services for the federal government and corporate clients in various parts of the [WORLD]. As part of its operations, the Taxpayer purchases tangible personal property from out-of-state vendors and imports the property into Tennessee prior to exporting the property for use in other [LOCATIONS].

The Taxpayer purchases uniforms for use in its business. At times, uniforms are imported into Tennessee, subjected to minor product examination to verify that products were as ordered, and shipped out of state for use.

The Taxpayer also purchases [TANGIBLE PERSONAL PROPERTY], which are shipped to a warehouse in Tennessee so that paperwork can be completed prior to exporting the [TANGIBLE PERSONAL PROPERTY] to foreign countries. While the [TANGIBLE PERSONAL PROPERTY] are in Tennessee, the Taxpayer might apply asset tags to [TANGIBLE PERSONAL PROPERTY], check to verify that products correlate to shipment documents, and consolidate [TANGIBLE PERSONAL PROPERTY] into larger shipping containers.

[REDACTED].

The Taxpayer also performs a small percentage of its services for the federal government within the foreign trade zone located in Tennessee. As part of these services, the Taxpayer sells various [TANGIBLE PERSONAL PROPERTY] without markup to the federal government, and after the sale uses the [TANGIBLE PERSONAL PROPERTY] in the course of providing services to the federal government.

RULINGS

1. Does the fact that the Taxpayer operates within a foreign trade zone as defined in TENN. CODE ANN. § 7-85-102 (2011) affect the application of the Tennessee sales, use, and business taxes to the Taxpayer's activities?

Ruling: No. Only Tennessee's *ad valorem* taxes are affected by the laws applicable to entities operating in foreign trade zones. As privilege taxes, the Tennessee business, sales, and use taxes are all unaffected by the fact that the Taxpayer operates within a foreign trade zone.

2. Is the Taxpayer liable for the Tennessee use tax on [TANGIBLE PERSONAL PROPERTY] that are imported into Tennessee but exported prior to use?

Ruling: No. The Taxpayer is not liable for the Tennessee use tax on any [TANGIBLE PERSONAL PROPERTY] that the Taxpayer imports into Tennessee and stores for inspection, tagging, and repackaging prior to export.

3. [REDACTED].

4. Does the Taxpayer owe Tennessee sales or use tax on property sold to the federal government, but used by the Taxpayer in the performance of its contract with the federal government?

Ruling: The Taxpayer must pay either the Tennessee sales tax or the Tennessee use tax on such property. If the Taxpayer purchases such property under a resale certificate, the Taxpayer will be liable for the Tennessee use tax. The Taxpayer may choose instead to pay Tennessee sales tax upfront on its purchase of such property; in such cases, use tax will not be owed.

5. For Tennessee business tax purposes, which classification applies to the Taxpayer?

Ruling: The Taxpayer conducts the taxable activities of a Classification 3 and Classification 4 business. However, the Taxpayer may only have one classification for purposes of the Tennessee business tax. As discussed below, the Taxpayer should first use the “largest proportion of gross sales” analysis to determine whether it is a Classification 3 or Classification 4 taxable business. If the Taxpayer is a Classification 3 business, the Taxpayer should use the “more than half” analysis discussed below to determine the applicable tax rate.

ANALYSIS

1. Tennessee sales, use, and business taxes apply to entities operating within foreign trade zones.

The Taxpayer operates at certain times out of a foreign trade zone located within Tennessee.¹ Federal law exempts certain tangible personal property held in foreign trade zones from “State and local ad valorem taxation,”² and TENN. CODE ANN. § 67-5-220 (2013) (relating to property taxes) also exempts certain tangible personal property held in foreign trade zones from “Tennessee ad valorem taxation.” However, Tennessee’s business tax, sales tax, and use tax are all privilege taxes, not ad valorem taxes, and are therefore unaffected by foreign trade zones.³

Accordingly, none of the taxes discussed in this letter ruling are affected by the Taxpayer operating in a foreign trade zone within Tennessee.

2. Tangible personal property imported for export is not subject to the Tennessee use tax.

TENN. CODE ANN. § 67-6-203(a) (2013) levies a tax on tangible personal property that is “used, consumed, distributed, or stored for use or consumption in this state.” Although “use” is defined broadly to include “the exercise of any right or power over tangible personal property incident to the ownership thereof,”⁴ TENN. CODE ANN. § 67-6-313(a) (2013) confirms that “[i]t is not the intention of this chapter to levy a tax upon articles of tangible personal property imported into this state or produced or manufactured in this state for export.”

¹ Foreign trade zones are established in this state under Tennessee’s Foreign Trade Zone Act, TENN. CODE ANN. §§ 7-85-101 to -103 (2011). Section 102(1) defines “foreign trade zone” to have the same meaning as the federal “foreign trade zone established pursuant to 19 U.S.C. §§ 81a-81u.”

² 19 U.S.C.A. § 81o (West, Westlaw through P.L. 113-36).

³ For sales and use taxes, see *Madison Suburban Util. Dist. v. Carson*, 232 S.W. 2d 277, 280 (Tenn. 1950) (“The Sales Tax and the Use Tax are both privilege taxes.”) and *Hooten v. Carson*, 209 S.W. 2d 273, 274 (Tenn. 1948). For business tax, see Tenn. Rev. Rul. 99-32 (Dec. 7, 1999) (concluding that a taxpayer operating within a foreign trade zone is nonetheless subject to the Tennessee business tax).

⁴ TENN. CODE ANN. § 67-6-102(94)(A) (2013).

Accordingly, based on the facts presented, the Taxpayer is not liable for use tax on any [TANGIBLE PERSONAL PROPERTY] that the Taxpayer purchases outside Tennessee,⁵ then imports into Tennessee and stores for inspection, tagging, and repackaging prior to export.

3. [REDACTED].

4. Sales or use tax must be paid on items sold to the federal government but used by the Taxpayer in the performance of its contract with the federal government.

Contractors doing work for the U.S. Government are not exempt from paying Tennessee sales tax on their purchases of tangible personal property,⁶ and the Taxpayer must pay the Tennessee sales and use tax on tangible personal property it uses in performance of its contracts if a sales or use tax has not already been paid on the property.

A contractor may not use a resale certificate to purchase property when the contractor “contracts for the installation of such tangible personal property as an improvement to realty.”⁷ Even where use of a resale certificate may be valid, TENN. CODE ANN. § 67-6-209(b) (2013) requires a contractor to pay use tax on tangible personal property used in performance of a contract if sales or use taxes have not already been paid. The statute, commonly known as the “contractors’ use tax,” reads in pertinent part:

Where a contractor or subcontractor defined in this chapter as a *dealer* uses tangible personal property in the performance of the contract, or to fulfill contract or subcontract obligations, whether the title to such property be in the contractor . . . or any other person, or whether the title holder of such property would be subject to pay the sales or use tax, . . . such contractor or subcontractor shall pay a tax at the rate prescribed by § 67-6-203 measured by the purchase price of such property, *unless such property has been previously subjected to a sales or use tax, and the tax due thereon has been paid.*⁸

The Supreme Court of the United States has upheld the constitutionality of this tax when applied to “contractors doing business with the United States, even though the economic burden of the tax, by contract or otherwise, is ultimately borne by the United States.”⁹

The term “dealer” is defined by TENN. CODE ANN. § 67-6-102(23)(K) to include any person who

⁵ Property purchased in Tennessee is subject to the sales tax under TENN. CODE ANN. § 67-6-202 (2013), and TENN. CODE ANN. § 67-6-313(a) does not prevent taxation of property that is purchased in Tennessee, even if purchased exclusively for export. See *Jack Daniel Distillery v. Jackson*, 740 S.W.2d 413 (Tenn. 1987).

⁶ TENN. COMP. R. & REGS. 1320-5-1-.58(2) (1974).

⁷ TENN. CODE ANN. § 67-6-209(c) (2013) states that “the transfer of tangible personal property by a contractor who contracts for the installation of such tangible personal property as an improvement to realty does not constitute a sale.” Since such transfers from the contractor to someone else are not sales, the contractor is not reselling property and is therefore not entitled to use a resale certificate.

⁸ TENN. CODE ANN. § 67-6-209(b) (2013) (emphasis added).

⁹ *U.S. v. Boyd*, 378 U.S. 39, 44 (1964) (internal citations omitted).

Uses tangible personal property, whether the title to such property is in such person or some other entity, and whether or not such other entity is required to pay a sales or use tax, in the performance of such person's contract or to fulfill such person's contract obligations, unless such property has previously been subjected to a sales or use tax, and the tax due thereon has been paid.

To the extent that the Taxpayer uses tangible personal property in the performance of its contract on which a sales or use tax has not been paid, the Taxpayer is a "dealer" as defined in TENN. CODE ANN. § 67-6-102(23)(K) and is subject to the contractors' use tax levied by TENN. CODE ANN. § 67-6-209(b).

Based on the facts provided, the Taxpayer must pay the Tennessee sales and use tax on untaxed tangible personal property owned by the federal government but used by the Taxpayer in the performance of its contract. If the Taxpayer uses tangible personal property on which sales or use tax has not already been paid, the Taxpayer must accrue and remit use tax on property so used.

5. The Taxpayer is subject to the Tennessee business tax as either a Classification 3 or Classification 4 taxable business, depending on the Taxpayer's dominant business activity.

The Tennessee Business Tax Act¹⁰ 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 2013,¹¹ which is effective for tax periods beginning on or after January 1, 2014.¹² This ruling will address the issues by applying the law as it exists as of the date of this letter; the analysis will not differ under the applicable provisions of the Uniformity and Small Business Relief Act of 2013.¹³

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.¹⁴ 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

¹⁰ 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)).

¹¹ Uniformity and Small Business Relief Act of 2013, ch. 313, §§ 1-23, 2013 Tenn. Pub. Acts __ (to be codified in various sections of Part 7 of Chapter 4 of Title 67).

¹² *Id.* at § 23.

¹³ 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 Sept. 3, 2013).

¹⁴ TENN. CODE ANN. § 67-4-709 (2013).

mean “[t]he item comprising the largest proportion of gross sales of the business when compared with other items sold.”¹⁵

Businesses whose dominant business activity involves “making sales of services or engaging in the business of furnishing or rendering services” fall under Classification 3.¹⁶ Businesses whose dominant business activity involves “contracting or performing a contract or . . . persons receiving compensation from . . . installing personal property, [or] from constructing, building, erecting, repairing, grading, excavating, drilling, exploring, testing, or adding to any building, . . . or structure or part thereof,” fall under Classification 4.¹⁷

Based on the facts provided, the Taxpayer engages in activities associated with both Classifications 3 and 4. The Taxpayer must determine which kind of activity comprises the largest portion of its gross sales. The classification in which that activity falls is the Taxpayer’s proper business tax classification. If the Taxpayer’s classification ever changes, the Taxpayer must file a final business tax return under its prior classification within fifteen days of the change.¹⁸

The rate of the business tax depends on the Taxpayer’s classification. For Classification 3 businesses, the business tax rate is three sixteenths of one percent (0.1875%) of all sales by a retailer or three eightieths of one percent (0.0375%) of all sales by a wholesaler.¹⁹ The Taxpayer must pay the business tax rate of a “wholesaler” if more than 50% of the Taxpayer’s taxable gross sales are wholesale sales,²⁰ otherwise the Taxpayer is taxed as a “retailer.”²¹

For purposes of the business tax, Tennessee defines “retail sale” by exclusion as anything that is not a wholesale sale, and TENN. CODE ANN. § 67-4-702(a)(24) defines “wholesale” to include (A) sales to retailers for resale, (B) sales of certain component parts for manufacturing property for resale, (C) sales by a wholesaler of tangible personal property to users exempt from paying

¹⁵ 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.

¹⁶ See TENN. CODE ANN. § 67-4-708(3)(C) (2013).

¹⁷ TENN. CODE ANN. § 67-4-708(4) (2013).

¹⁸ DEP’T OF REVENUE, BUSINESS TAX GUIDE 11 (Oct. 2012).

¹⁹ TENN. CODE ANN. § 67-4-709(3) (2013).

²⁰ TENN. CODE ANN. § 67-4-702(a)(25) (2013).

²¹ TENN. CODE ANN. § 67-4-702(a)(16).

other taxes including the federal government,²² and (D) certain sales made by franchised motor vehicle dealers.

Of the activities described in the facts, only the Taxpayer's sales of [TANGIBLE PERSONAL PROPERTY] to the federal government would constitute wholesale sales. Everything else described in facts are retail sales.

Classification 4 businesses enumerated in § 67-4-708(4)(A) are taxed at one tenth of one percent (0.1%) of "the compensation entitled to under the contract, whether in the form of a contract price, commission, fee or wage." If the Taxpayer is a Classification 4 business, this is the appropriate rate of tax.

For purposes of the business tax, the Taxpayer should first use the "largest proportion of gross sales" analysis to determine whether it is a Classification 3 or Classification 4 taxable business. If the Taxpayer is a Classification 4 business, the proper tax rate is 0.1% of compensation entitled to under contract. If the Taxpayer is a Classification 3 business, the Taxpayer should use the "more than half" analysis to determine whether it qualifies for the reduced wholesaler rate of 0.0375% of sales, otherwise the proper rate is 0.1875% of sales.

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APPROVED: Richard H. Roberts
Commissioner of Revenue

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²² See TENN. COMP. R. & REGS. 1320-4-5-.50 (1974).