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Chapter 2: Who is Subject to Tennessee Business Tax?

Historical Context

As covered in Chapter 1, the Tennessee business tax has undergone numerous statutory changes to adapt to modern business practices and e-commerce. One of the most important changes is to the application of “nexus,” which describes the connection that must be present before a taxing jurisdiction has the right to impose a tax on a business. An entity must have some contact or connection with a state before the state may constitutionally levy a tax. The question becomes, at what point is that connection sufficient to subject a person to taxation in the state?

1. Pre-2014 Tax Periods

For periods beginning on or before January 1, 2014, Tennessee law provided that making sales by engaging in any vocation, occupation, business or business activity listed in the business tax statutes is a privilege on which each county or incorporated municipality, or both, may levy a privilege tax.¹

Furthermore, TENN. COMP. R. & REGS. 1320-04-05-.28(1) (2000) (“Rule 28”) stated that the business tax applies to each place, location, or outlet in the state from which business is carried on.

Therefore, the Tennessee business tax applied to a person who made sales or performed services at a place of business or other location in Tennessee.

During this period, the Department considered a taxpayer that did not have a physical place of business in Tennessee, but that operated through a warehouse or other location in Tennessee, whether or not the warehouse or other location is owned by the taxpayer, to have a business location where its sales were sourced. This was based on TENN. COMP. R. & REGS. 1320-04-05-.14 (“Rule 14”). Rule 14 states that:

- “[S]ales of tangible personal property and services by a licensed wholesaler or retailer from a central warehouse or other distribution point other than his principal place of business shall be subject to the appropriate wholesale or retail tax, and persons making such sales shall be liable for the business tax for that location.”

Accordingly, the Department imposed business tax on sales of tangible personal property made from a warehouse or other location in Tennessee at which a taxpayer maintained the tangible personal property sold.

The Department also utilized the “sufficient local incidence” test. The United States Supreme Court coined the term “sufficient local incident” to illustrate when a business’s in-state activity rose to the level to contribute to the establishment and maintenance of an in-state market. This level of activity was sufficient to satisfy U.S. Constitutional requirements.²

In *Westinghouse Electric Corp. v. King*, 678 S.W.2d 19 (Tenn. 1984), the Tennessee Supreme Court established as the relevant question of whether a taxpayer is subject to the business tax as whether there is a “sufficient local incident” upon which to base the tax. It concluded that a taxpayer who had marketing offices within the state and technical engineers performing work within the state had “sufficient local incident” to Tennessee such that its receipts from its sales to Tennessee customers were subject to business tax.

In *Boeing Equipment Holding Company v. Tennessee State Board of Equalization*, 1987 WL 15202 (Tenn. Ct. App., August 7, 1987), the Tennessee Court of Appeals found an out-of-state taxpayer subject to business tax even though it had no offices or employees in Tennessee. To take advantage of an *ad valorem* tax exemption for inventories located in the state, the taxpayer argued it was subject to business tax based on the presence of tangible personal property leased to persons in Tennessee. The court found the taxpayer had a “sufficient local incident” based on the taxpayer owning property in Tennessee and receiving income from leases on that property. It concluded that the taxpayer “engaged in the ‘local business of renting [property] located in this state.’”³

The *Westinghouse* and *Boeing* cases both suggested that a taxpayer need not have an office or physical business location in Tennessee to be subject to business tax.

2. Periods Beginning on or after January 1, 2014

The Tennessee General Assembly clarified the application of the business tax as applied to out-of-state businesses with the “Uniformity and Small Business Relief Act of 2013” (the “Act”).

Effective for periods beginning on or after January 1, 2014, the law was amended to state the following:

- [T]he making of sales by engaging in any vocation, occupation, business, or business activity listed described, or referred to in § 67-4-708(1)-(5)" (the classifications section of the business tax statute) is subject to the state-level business tax.⁴
- [T]he making of sales by engaging in any vocation, occupation, business, or business activity listed, described, or referred to in § 67-4-708(1)-(4)" (the classifications section of the business tax statute) is subject to the municipal-level business tax.⁵

The Act also added that:

- [A]ny person engaged in any vocation, occupation, business, or business activity listed, described, or referred to in § 67-4-708(1)-(5) **without** establishing a physical location, outlet, or other place of business in the state" is subject to the state-level business tax but **exempt** from the municipal-level business tax.⁶
- For purposes of the state-level business tax, to be engaged in business in this state includes performing a service that is received by a customer in this state.⁷
- Thus, for periods beginning after January 1, 2014, a taxpayer need not have a location in Tennessee to be subject to the state-level business tax but must have a physical location to be subject to the municipal-level business tax.

Present Law

A business entity located in the state will be subject to the state-level business tax if its gross receipts sourced to all of its locations within a county are \$10,000 or more, and it is not specifically exempt from business tax.⁸ An entity is also subject to the municipal-level business tax if it is in a municipality that has enacted the tax and its gross receipts sourced to its locations within the municipality are \$10,000 or more.⁹ (See Chapter 7 for more information on sourcing). Please note, there are provisions that apply to telecommunications and cable providers, vending machine operators, and overnight lodging rentals. These provisions are discussed later in this Manual.

A business entity that is located *outside* of the state will be subject to the state-level business tax if it has:

- *Substantial nexus* with the state;
- Is *engaged in this state* in one of the activities listed under Tenn. Code Ann. § 67-4-717(a); and
- Its gross receipts within a county are \$10,000 or more.

As stated in Chapter 1, the business tax is comprised of a state-level tax and a municipal-level tax. Out-of-state business entities are exempt from the municipal-level business tax.

1. Substantial Nexus

A business must have substantial nexus with this state to be subject to the business tax. The Revenue Modernization Act (“the RMA”) codified the substantial nexus standard in 2015. It became effective for tax years beginning on or after January 1, 2016. Substantial nexus is:

- Any direct or indirect connection of the taxpayer 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.”¹⁰ Such connections include, but are not limited to, the following:
 - The business is organized or commercially domiciled in Tennessee;
 - The business owns or uses its capital in Tennessee;
 - The business has systematic and continuous business activity in Tennessee that has produced gross receipts attributable to customers in Tennessee;
 - The business has a “bright-line presence” in Tennessee, which applies when any of the following metrics are met:
 - Total Tennessee business receipts during the tax period exceed the lesser of \$500,000 or 25% of the business’s total receipts everywhere during the tax period;

- The business's average value of real and tangible personal property owned or rented and used in Tennessee during the tax period exceeds the lesser of \$50,000 or 25% of the average value of all the business's total real and tangible personal property; or
- The total amount of compensation paid by the business in Tennessee during the tax period exceeds \$50,000 or 25% of the business's total compensation pay by the business.¹¹

⚠ Businesses formed and operating in Tennessee will always have nexus in this state. The question of nexus applies to out-of-state businesses with a limited connection to the state.

Foreign entities must have effectively connected income with a United States trade or business, as determined by the Internal Revenue Code ("IRC"), to have substantial nexus in this state. If a business treated as a foreign corporation under the IRC has no effectively connected income, it also does not have substantial nexus in Tennessee.

Effective for tax periods beginning January 1, 2016, the RMA's substantial nexus standard expands the number of businesses that might have nexus in Tennessee. Businesses that would have been subject to the business tax before the RMA (and the substantial nexus definition) will continue to be subject to the tax even if they do not meet any of the bright-line tests. However, under the substantial nexus definition, some out-of-state businesses that previously were not subject to business tax may now be subject to the tax. In other words, the nexus provisions in existence pre-RMA are still in effect, RMA simply expanded upon those provisions.

⚠ It is not required that a taxpayer have bright-line presence to have substantial nexus with Tennessee. A taxpayer may have substantial nexus with Tennessee with lesser amounts of property, payroll, and receipts in Tennessee if it has any connection with the state that requires it to remit tax under the United States Constitution, such as performing services in the State.

2. Activities Engaged in this State

In addition to having substantial nexus, a business must also be engaged in one of the activities in Tenn. Code Ann. § 67-4-717(a) before being subject to the business tax. This

section states that a business “engaged in this state” in any “vocation, occupation, business, or business activity set forth as taxable under § 67-4-708(1)-(5), the classifications section of the business tax statute, with or without establishing a physical location, outlet, or other place of business in the state, shall be subject to the tax.” The phrase “engaged in this state” shall include, but not be limited to, any of the following:

- The sale of tangible personal property that is shipped or delivered to a location in this state;
- The sale of a service that is delivered to a location in this state; or
- The leasing of tangible personal property that is located in this state.¹²

3. Nexus in Tennessee – Other Tennessee Taxes

As mentioned above, nexus describes a connection that must be present before a taxing jurisdiction has the right to impose a tax on an entity’s activity. Determining whether a taxpayer has nexus in Tennessee for business tax is a different process than the determination of whether a taxpayer has nexus for Tennessee sales and use tax and franchise and excise tax. However, all businesses located in this state have nexus for sales and use tax, franchise and excise tax, and business tax.

Sales and Use Tax

Out-of-state dealers engaged in the following activities are considered to have nexus in this state:

- Use of employees, agents or independent contractors to solicit sales in Tennessee;
- Use of third parties in Tennessee to conduct substantial business activities in Tennessee;
- Maintaining inventory in Tennessee and using in-state independent contractors to fulfill Tennessee retail sales of that inventory;
- In-state promotional activity by company personnel, including participation in trade shows;

- Physical Tennessee business presence of a subsidiary that is acting as an agent of the out-of-state dealer or that is conducting activities in Tennessee on behalf of such a dealer (e.g., a retail store that takes returns of purchases made online from parent);
- Use of company-owned trucks or use of contract-carriers acting as an agent for the seller;
- Maintaining a store, office, warehouse, showroom, or other place of business in Tennessee;
- Leasing or renting tangible personal property in Tennessee;
- Repairing, installing, or assembling tangible personal property in Tennessee or the use of an agent or independent contractor to perform those services in Tennessee;
- Providing telecommunication services to subscribers located in Tennessee;
- Providing any taxable service in Tennessee; and
- Use of an in-state party to route customers to the out-of-state dealer (commonly known as “click-through nexus”).

Pursuant to the Wayfair decision, out-of-state dealers with no physical presence in Tennessee that make sales that exceed \$100,000 to customers in this state during the previous tax year also have substantial nexus in Tennessee for sales and use tax purposes.

For more information on sales and use tax nexus requirements, see the Department’s Sales and Use Tax Manual.

Franchise and Excise Tax

A taxpayer without a physical presence in the state may have substantial nexus in the state for franchise and excise tax purposes if it meets the bright-line presence definition of substantial nexus. A taxpayer meets the bright-line presence standard for substantial nexus for franchise and excise tax if a taxpayer has:

- At least \$50,000 of property or payroll in the state;
- At least \$500,000 of receipts in the state; or
- At least 25% of its total property, payroll, or receipts in Tennessee.

A taxpayer that does not meet the bright-line presence standards may also have substantial nexus in the state if its contact with the state is sufficient. For example:

- A business engaged in systematic and continuous business activity in the state that has produced receipts attributable to Tennessee customers will have substantial nexus with the state.

For more information on nexus for franchise and excise tax, see the Department's Franchise and Excise Tax Manual.

4. Establishing a Location, Outlet, or Other Place of Business

All persons that are subject to the state-level business tax and have a physical location, outlet, or other place of business within a municipality in this state shall also be subject to the municipal-level business tax. Persons that do not have a physical location, outlet, or other place of business within a municipality in this state shall not be subject to the municipal-level business tax.¹³

Persons engaged in the business of selling tangible personal property or services from a central warehouse or distribution point other than their principal place of business are liable for business tax at that location.¹⁴ For example:

- A furniture store is principally located in Nashville, Tennessee. The Nashville location is advertised on its website, the taxpayer lists this address on its registration documents, and this is where the showroom is located. The business also has a warehouse located in Murfreesboro, Tennessee. As new furniture models are introduced, the taxpayer occasionally holds "warehouse sales" whereby the warehouse is opened to the public to display and sell the overstock merchandise. The taxpayer, therefore, should register and pay business tax for its Murfreesboro location as well.

In the case of an audit, auditors will consider several factors when determining whether a taxpayer has established a location, outlet, or other place of business in Tennessee including:

- The amount of time a person has engaged in business in Tennessee;

- The regularity in which a person engages in business in Tennessee;
- Whether the business holds itself out as having a location in Tennessee;
- Taxable receipts generated within a jurisdiction;
- Whether or not employees of a business are located in this state;
- Whether or not the business has Tennessee payroll receipts in its franchise and excise tax apportionment factor;
- Whether the business intends to operate at a location in Tennessee on a more than temporary basis; and
- Whether or not a taxpayer leases or owns property in Tennessee.

This is not an exhaustive list of factors. Each business is unique; thus, an auditor may use other facts or circumstances to determine whether a seller of tangible personal property or a service provider has established a location. For example:

- A California information technology ("IT") consultancy firm ("CA IT Company") enters into a 2-year contract with a Memphis, Tennessee business. The contract is valued at \$5,000,000 dollars and the CA IT Company will have a team of 20 consultants working full-time from the Memphis business's headquarters. The consultants will have designated parking spaces, designated office spaces, security access to the headquarters building, and access to the internet network. The CA IT Company has information on its website that it's performing work in numerous states and cities, including Memphis, Tennessee. Under these circumstances, the California IT Company has likely established a business location in Memphis, Tennessee and should register and pay both state-level and municipal-level Tennessee business tax.

¹ Tenn. Code Ann. § 67-4-704.

² *General Motors Corp. v. Washington*, 377 U.S. 436 (1964).

³ *Boeing Equipment Holding Company v. Tennessee State Board of Equalization*, 1987 WL 15202 (Tenn. Ct. App., August 7, 1987).

⁴ Tenn. Code Ann. § 67-4-704.

⁵ Tenn. Code Ann. § 67-4-705.

⁶ Tenn. Code Ann. § 67-4-717(a).

⁷ Tenn. Code Ann. § 67-6-717(a)(1).

⁸ Please note, Rule 14 is still in effect and is helpful in making this determination.

⁹ Please note, there are provision that apply to telecommunications and cable providers, vending machine operators, and overnight lodging rentals. These are discussed later in this Manual.

¹⁰ Tenn. Code Ann. § 67-4-702(a)(22)(A).

¹¹ Tenn. Code Ann. § 67-4-702(a)(22)(A)(i)-(iv)(c).

¹² Tenn. Code Ann. § 67-4-717(a)(1)(A)-(C). Please note, the following activity is also covered under this code section: "making sales as a natural gas marketer to customers located within this state through the presence in this state of the seller's property, through the holding of pipeline capacity by the seller on pipelines located in this state, or through the presence in this state of the seller's employees, agents, independent contractors, or other representatives acting on behalf of the seller to solicit orders, provide customer service, or conduct other activities in furtherance of such sales. For purposes of this subdivision (a)(1)(D), the phrase "presence in this state of the seller's property" shall include property owned by the seller in this state during delivery to the customer, whether in a pipeline or otherwise."

¹³ Tenn. Code Ann. § 67-4-717(a)(2).

¹⁴ TENN. COMP. R. & REGS. 1320-04-05-.14.