

*EXCISE AND MISCELLANEOUS TAXES*

## Wait, Tennessee Has a Gross-Receipts Tax?

*As of January 1, 2016, Tennessee's often overlooked business gross-receipts tax applies to any taxpayer with economic nexus in Tennessee.*

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When Tennessee passed the sweeping tax reform package titled the Revenue Modernization Act (or "RMA"), the state made headlines for its adoption of economic nexus and market-based sourcing for corporate income and franchise taxes. What you might have missed is that the RMA also adopted economic nexus for Tennessee's lesser-known gross-receipts tax—known as the "business tax"—with those provisions made effective January 1, 2016. Up to that point, the law was unclear whether businesses that had little to no physical presence in Tennessee could be subject to the business tax, with many businesses choosing to ignore the tax altogether and having no negative repercussions for doing so. Now, it is clear that the vast majority of businesses selling goods or services to Tennessee customers must pay the business tax.

This is just one of several indicators that Tennessee is reforming its application and enforcement of this once local tax. The Tennessee Department of Revenue has also expressly announced its intention to impose and enforce the tax broadly. "With a few exceptions," the Department's website advises, "all businesses that sell goods or services must pay the state business tax."<sup>1</sup> Consistent with this approach, the Department's auditors have been focused on compliance issues specifically related to the business tax in recent years, with most Tennessee audits concluding with the imposition of some additional business tax assessment. As this suggests, businesses can no longer afford to ignore Tennessee's gross-receipts tax.

If this is the first you've heard of Tennessee's gross-receipts tax, you're not alone. Despite being over 45-years old, the business tax has spent most of those years in relative obscurity. Many businesses diligently pay the state's better-known sales tax and corporate income and franchise taxes yet remain

completely unaware of their business tax obligations. And too often, taxpayers first learn of the business tax through surprising assessments of back taxes, penalties and interest.

For a tax imposed on "all businesses that sell goods or services" in Tennessee, the business tax's obscurity is as perplexing as it is problematic. For example, the Tax Foundation does not include Tennessee in its list of states imposing a gross-receipts tax.<sup>2</sup> Tennessee's Department of Revenue is also guilty of neglecting the business tax. As of the writing of this article, the Department has not updated its website to inform taxpayers of the new economic nexus provisions that took effect at the start of the year. Instead, both the business tax's homepage and an article titled: "I am an out-of-state business with no business locations in Tennessee. Do I owe business tax?" continue to give out-of-state taxpayers outdated guidance for determining whether they're subject to the tax.<sup>3</sup>

To better understand the business tax and its strange obscurity, it helps to understand the tax's circuitous origins. The business tax was adopted in 1971 as an alternative to local property taxes imposed on business inventories.<sup>4</sup> Like the property taxes it replaced, the business tax was originally administered by city and county officials.

Perhaps to leave more discretion to local administrators, the Business Tax Act of 1971 gave little guidance on many key issues. For example, the Act did not prescribe any rules for sourcing sales to Tennessee, let alone divvying sales between local jurisdictions. Rather, the business tax was literally imposed on "all the gross sales of the business," which taxpayers were instructed to report to each county and city in whatever manner prescribed by local officials.<sup>5</sup> Not surprisingly, the cities and counties were not always uniform in their interpretations of these and other ambiguities regarding how to impose the business tax, often resolving questions and complications on a case-by-case basis—and in many instances choosing not to enforce the tax at all.

In the intervening years, the business tax has undergone a gradual transformation from local oddity to a broad-based, state-imposed and enforced, gross-receipts tax. In 2009, the business tax was converted into a state tax administered by the Tennessee Department of Revenue.<sup>6</sup> Then, in 2013, the Tennessee General Assembly passed a package of comprehensive reforms, including a provision imposing business tax obligations on taxpayers operating from locations outside the state.<sup>7</sup> The RMA has completed this transformation, clearly imposing business tax on all persons that sell taxable goods or services into Tennessee and without regard for whether they have a physical presence in the state.

Although this transition has allowed taxpayers to address their returns and questions to a single agency, the Department has been slow to resolve the many areas of ambiguity and confusion that still exist in the tax

provisions. Consequently, taxpayers and the Department have continued to resolve business tax issues primarily on a case-by-case basis, using rough justice and rules of thumb rather than concrete principles and regulations. It is not surprising, then, that many out-of-state taxpayers and tax professionals have continued to dismiss the business tax as the purely local tax it once was.

To navigate the business tax, it helps to start with the basics and take absolutely nothing for granted. Accordingly, first-time (and current filers) may benefit from a brief primer on the most basic questions: What is the business tax? Who is subject to the tax? What is the tax rate? And what sales are included in the tax base?

## What Is the Business Tax?

The business tax is a broad-based gross-receipts tax imposed on all persons<sup>8</sup> selling taxable goods or services into Tennessee.<sup>9</sup> One unusual feature of the business tax is that it is imposed primarily on a location-by-location basis.<sup>10</sup> Each "physical location, outlet, or other place of business" within Tennessee must register separately for the business tax and file its own business tax returns reporting gross receipts from all sales attributable to that location. Locations outside Tennessee, however, are consolidated and treated as a single location for business tax purposes, registering and filing returns as a single out-of-state business.<sup>11</sup>

In addition to the state business tax, cities are authorized to impose copycat city business taxes on businesses within their borders. The city business tax is imposed in addition to the state business tax imposed on the same business.<sup>12</sup> Because most cities have adopted the city business tax—including Tennessee's four largest cities, Nashville, Memphis, Knoxville and Chattanooga—this means businesses that have physical locations inside a city typically pay the business tax twice on the same receipts attributable to those locations. The city business tax also doubles reporting requirements, as locations subject to the city business tax must register and file returns for both the state and city business tax.

The Tennessee Department of Revenue administers both the state and city business tax. Although all registrations and returns are filed with the Department, taxpayers still must file separate registrations and returns for each location subject to the business tax. By rule, the Department may permit taxpayers with multiple locations within the same city or county to file a consolidated return for that jurisdiction, as long as the taxpayer provides a schedule that divides all reported sales among each location within the jurisdiction.<sup>13</sup>

## What Businesses Are Subject to the Business Tax?

The business tax is imposed generally on anyone delivering goods or services to Tennessee customers, but a number of activities and entities are specifically exempted. For example, taxpayers are exempt from the business tax if they generate less than \$10,000 in sales. (In-state locations that generate less than \$10,000 in sales do not need to file business tax returns, but locations with more than \$3,000 in sales must pay a minimal activity fee to the cities and counties in which they are located.)

In addition, the following activities are exempt from tax: services performed in the course of employment;<sup>14</sup> sales made to wholesalers for resale;<sup>15</sup> occasional and isolated sales or transactions by a person not routinely engaged in business;<sup>16</sup> and certain services within the fields of law, accounting, human and veterinary medicine, animal boarding, domestic services, public utilities, banking, insurance, engineering and architecture, building management, farming, nonprofit, education, religion, and charity.<sup>17</sup>

Under the new economic nexus rules, any business that derives at least \$500,000 from sales to Tennessee customers will be presumed to have substantial nexus in Tennessee and required to pay the business tax.<sup>18</sup> Because the business tax is imposed on gross receipts, not net income, taxpayers cannot rely on Public Law 86-272 to shield them from these obligations.<sup>19</sup> In addition, even if the \$500,000 threshold is not met, taxpayers will potentially be subject to the tax on sales to Tennessee that can, in any way, be connected to an in-state presence.

## What's the Tax Rate?

The business tax imposes multiple tax rates, ranging widely from 0.02% to 0.3%, depending on a taxpayer's particular classification. Classifications and tax rates are applied on a location-by-location basis.<sup>20</sup> Every in-state location has its own classification for business tax purposes, and the corresponding tax rate is applied to all receipts from taxable sales made by (or attributed to) that location. Because out-of-state locations are consolidated for business tax purposes, taxpayers with no locations in Tennessee have only one classification and pay the business tax at the same rate on all receipts from taxable sales.

Taxpayers are required to determine their proper tax classification upon registration, which means that taxpayers (and tax administrators providing informal, non-binding guidance) have a tendency to classify businesses based on rough generalizations. The actual rules governing classification are extremely technical, however, and taxpayers taking such a rough justice approach might unknowingly accrue many

years of under- or over-payments. Accordingly, taxpayers are better advised to give appropriate time and attention to choosing the correct classification.

There are ten principal classifications (Classes 1A, 1B, 1C, 1D, 1E, 2, 3, 4, 5A and 5B), defined based on the kinds of businesses included in each classification and with a specific tax rate applicable to each classification. Most classifications also impose different rates on wholesalers and retailers.<sup>21</sup> To determine the correct rate to use when paying the business tax, therefore, taxpayers must first determine their proper classification and then, if necessary, determine whether they qualify as a wholesaler or retailer for business tax purposes.

A taxpayer's classification at each location in Tennessee is determined based on its "dominant business activity" at that location (with places of business outside the state being consolidated and treated as a single location for this purpose). By statute, "dominant business activity" is defined as "the business activity that is the major and principal source of taxable gross sales of the business" location.<sup>22</sup> The terms "major" and "principal" could have a holistic, qualitative meaning, but the Department has opted for a strictly quantitative test: "The item comprising the largest proportion of taxable gross sales of the business when compared with other items sold determines its classification."<sup>23</sup> Both the statutory and regulatory definitions of "dominant business activity" focus solely on taxable sales. Taxpayers should be careful to exclude exempt sales when testing for their "dominant business activity" and should be aware that assessments or refunds changing the taxable nature of their sales could also change their "dominant business activity."

The Department's quantitative test for determining "dominant business activity" may provide more certainty and objectivity at the outset, but it can be problematic for businesses that derive roughly equal receipts from multiple lines of business. The Department requires taxpayers to change classification whenever their "character of business changes in a manner that causes the taxpayer to fall under a different business tax classification."<sup>24</sup> Under the Department's strictly quantitative definition of "dominant business activity," it is possible for a taxpayer's classification to fluctuate year to year. As a result, taxpayers with varied kinds of sales must routinely test and re-test for their dominant business activity.

Once a taxpayer has identified "the item" generating the most taxable sales, the next step is to determine the correct business tax classification for that item. For some taxpayers, this step will be easy. For example, taxable services are generally Class 3 activities, with very few and readily apparent exceptions. Other types of activities, however, are classified at a granular level and categorized across several classifications with little to no obvious reason.

For example, food products straddle at least three classifications, requiring those in the retail food industry to distinguish between sales of food "destined for home preparation" (Class 1A, taxed at 0.1%), "prepared food" (Class 2, 0.15%), and "delicatessens and candy" (Class 3, 0.1875%). When the lines between classifications are this specific, taxpayers must be equally exacting when calculating and classifying their "dominant business activity."

Finally, most business tax classifications also distinguish between wholesalers and retailers. When this is the case, wholesalers are given preferential rates, sometimes as low as 1/5 of the corresponding retail rate.<sup>25</sup> In the past, the "wholesale" rate only applied to wholesale sales. Now, however, the law requires an all or nothing rule where a location qualifying as a "wholesaler" may use the preferential rate for all sales (wholesale and retail).<sup>26</sup> All other locations must pay entirely under the retail rate, even on receipts from true wholesale sales. Accordingly, once a taxpayer has determined the proper classification for a location, it may be necessary to further determine whether that location qualifies as a "wholesaler" for business tax purposes.

The business tax defines "wholesaler" and "retailer" based on the business' taxable sales. A business is considered a "wholesaler" if it derives more than half of its taxable sales from wholesale sales, otherwise it is considered a "retailer."<sup>27</sup> For this purpose, a wholesale sale is a sale made to a retailer for resale,<sup>28</sup> a sale of component parts for the manufacture and resale of other articles,<sup>29</sup> or a sale made to the Tennessee government or nonprofit institution.<sup>30</sup>

Wholesale sales do not include, however, any sales made to other wholesalers. Sales made to wholesalers for resale are not taxable and are excluded from consideration and taxation.<sup>31</sup> Sales made to wholesalers for their own use, on the other hand, are considered to be retail sales.<sup>32</sup> It is also worth noting that sales made to retailers only qualify as wholesale sales if the buyer remains a "retailer" for business tax purposes, something sellers may not routinely know about their customers. This interplay could create headaches for industries where sellers regularly sell to wholesalers, retailers, and end users alike.

## What Sales Are Included in the Tax Base?

Once a taxpayer has registered its business locations and determined the correct classifications and tax rates, all that remains is to determine the correct tax base. Broadly speaking, business tax is imposed on the gross receipts from taxable goods and services delivered to Tennessee customers.<sup>33</sup> This appears straightforward enough, but there are several potential pitfalls to avoid when determining what sales are

taxable, whether a sale is "delivered" in Tennessee, and which location is responsible for the sale (i.e. which location to tax).

First, it is critical to remember that, unlike the sales tax, Tennessee's business tax is imposed on nearly every kind of service. This includes inter-company services for which receipts are generated by the company providing the service. As a result, management services, shared services, and the like are all potentially taxable. In addition, purely personal services—like gardening, haircuts, etc.—are all subject to the business tax, unless expressly exempted by statute. Indeed, Tennessee recently highlighted the scope of the business tax by issuing a notice making it clear that the tax applied to gross receipts from live musical performances.<sup>34</sup> As this suggests, any time payment is made for a service provided in or delivered to Tennessee, it is likely subject to the business tax.

As a result, it is also crucial to determine which sales of services or products are delivered to customers in Tennessee for business tax purposes. Although sourcing sales is perhaps the most basic requirement for a gross-receipts tax, the business tax is largely silent on the topic. The Department has promulgated a rule stating that receipts from sales of tangible personal property and services are subject to the business tax if the property or service is "delivered" to the customer in Tennessee.<sup>35</sup> On the other hand, sales of property or services "delivered" outside Tennessee are not subject to the tax.<sup>36</sup> This rule is not particularly helpful, however, as those familiar with sales tax and sales-factor sourcing for corporate income taxes know there is more than one way to interpret delivery, particularly in the case of services (and even more so for those services "delivered" electronically, such as cloud computing services).

To address this issue, it seems likely that Tennessee will adopt the same market-based rules for the business tax that it recently adopted for purposes of calculating sales factors for franchise and excise tax purposes. After all, taxpayers must already use these rules for purposes of determining whether they are subject to business tax under the new economic nexus provisions.<sup>37</sup> Nevertheless, the Department has not expressly adopted these rules at this time, passing up several opportunities to do so when amending its business tax regulations and other published guidance earlier this year. This may suggest the Department has not yet made up its own mind on this matter.

Once a taxpayer has determined which taxable sales are delivered to Tennessee, the taxpayer must then allocate those sales between its tax-paying locations. Here, at least, the business tax does provide specific rules, but those rules are not easily applied to all situations. Generally, sales are sourced to the location whose operations generated the sale.<sup>38</sup> In-state locations are responsible for reporting all sales made on the premises or through "extend[ing] their operations" elsewhere. Sales made from out-of-state operations

are treated as though made from a single out-of-state location and reported on the taxpayer's consolidated out-of-state business tax return.

These rules are straightforward when applied to sales that may be clearly tied to operations at a particular location, such as a retail outlet or sales office. The rule breaks down, however, when two or more locations operate in tandem to sell a good or service, and the Department has not yet provided clear guidance on how taxpayers should apportion such sales.

## Conclusion

The Tennessee business tax has been long ignored for a reason. The tax was designed as a rough justice alternative to local property taxes and never intended to be a broad-based tax on interstate commerce. This has become increasingly clear over the past decades, as Tennessee's lawmakers and administrators have attempted to shoehorn more taxpayers and more activity into the business tax's outdated provisions.

Now that Tennessee has extended this tax beyond its borders and the Department has begun enforcing the tax more consistently, these flaws will need to be addressed. For instance, even though the tax is now being enforced and imposed broadly, the following basic and fundamental questions are still open to debate:

- What rules or principles should taxpayers use to determine whether a product or service has been delivered to a Tennessee customer?
- When multiple locations work together to sell the same good or services, how should receipts from that sale be divided between those locations for business tax purposes?
- If a taxpayer has a headquarters or back-office support location in Tennessee but that location does not actively participate in selling the business' goods or services, is that location subject to Tennessee business tax? If so, how does the state determine which sales are attributed to those locations?
- May taxpayers rely on sales tax resale certificates to determine whether a taxable sale is considered a wholesale sale for business tax purposes?
- If an out-of-state business sells differently classified products or services from separate out-of-state locations, may the taxpayer register those locations under separate classifications and report sales from each location on separate out-of-state business tax returns?

These are just a sample of the important questions that are still not answered when it comes to imposing Tennessee's business tax. Hopefully, with time and subsequent clarifying legislation and regulations, these

and the other questions implicit in the business tax will be resolved. Whatever the future may hold for Tennessee's business gross-receipts tax, it is likely to be anything but business as usual.

<sup>1</sup> Tenn. Dep't of Rev., *Business Tax: Overview*, available at <http://www.tn.gov/revenue/topic/business-tax> (last visited Oct. 12, 2016).

<sup>2</sup> Tax Foundation, *Facts & Figures 2015*, available at <http://taxfoundation.org/article/facts-figures-2015-how-does-your-state-compare>. This oversight is particularly telling because the Tax Foundation has spent the past decade waging a policy war against gross-receipts taxes and has generally been very diligent and thorough in documenting and commenting on other state's gross-receipts taxes. See, e.g., Chris Atkins, *Gross-receipts tax: Wrong Way to Finance Illinois Government*, March 7, 2007, available at <http://taxfoundation.org/blog/gross-receipts-tax-wrong-way-finance-illinois-government>; Joseph Henchman, *Hawaii's Gross-receipts tax: Economically Damaging Despite Low Rate*, Dec. 15, 2009, available at <http://taxfoundation.org/blog/hawaiis-gross-receipts-tax-economically-damaging-despite-low-rate>; and Liz Malm, *Nevada Voters to Consider Economically Damaging Gross-Receipts-Style Tax, a Type Only Five Other States Have*, Oct. 28, 2014, available at <http://taxfoundation.org/blog/nevada-voters-consider-economically-damaging-gross-receipts-style-tax-type-only-five-other-states>.

<sup>3</sup> Tenn. Dep't of Rev., *Business Tax: Overview*, available at <http://www.tn.gov/revenue/topic/business-tax> (last visited Oct. 12, 2016); Tenn. Dep't of Rev., *I am an out-of-state business with no business locations in Tennessee. Do I owe business tax?* available at <https://revenue.support.tn.gov/hc/en-us/articles/203148059-I-am-an-out-of-state-business-with-no-business-locations-in-Tennessee-Do-I-owe-business-tax-> (last visited Oct. 12, 2016).

<sup>4</sup> 1971 Pub. Acts, c. 387, prmb1.

<sup>5</sup> 1971 Pub. Acts, c. 387, §§ 6-7.

<sup>6</sup> 2009 Pub. Acts, c. 530, §§ 69-93 (eff. Jul. 1, 2009).

<sup>7</sup> 2013 Pub. Acts, c. 313, § 18 (eff. Jan. 1, 2014).

<sup>8</sup> The definition of "person" for business tax purposes "includes any individual, firm, partnership, joint venture, association, corporation, estate, trust, business trust, receiver, syndicate, or other group or combination acting as a unit." Tenn. Code Ann. § 67-4-702(a)(13).

<sup>9</sup> Tenn. Code Ann. § 67-4-704(a).

<sup>10</sup> See, e.g., Tenn. Comp. R. & Regs. § 1320-04-05-.28, -.53.

<sup>11</sup> See Tenn. Code Ann. § 67-4-717(b)(1).

<sup>12</sup> Tenn. Code Ann. §§ 67-4-705, -717(c). The Tennessee Department of Revenue publishes a comprehensive list of cities imposing the city business tax. This list is currently available at <http://www.tn.gov/assets/entities/revenue/attachments/comprehensivelisting.pdf> (last accessed Oct. 12, 2016).

<sup>13</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.28(1).

<sup>14</sup> Tenn. Code Ann. § 67-4-712(b)(1).

<sup>15</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.47(3).

<sup>16</sup> Tenn. Code Ann. § 67-4-702(a)(2).

<sup>17</sup> Tenn. Code Ann. § 67-4-708(3)(C).

<sup>18</sup> Tenn. Code Ann. §§ 67-4-702(a)(22)(A), -717(a)(1) (eff. Jan. 1, 2016).

<sup>19</sup> 15 U.S.C.A. § 381(a).

<sup>20</sup> See Tenn. Comp. R. & Regs. § 1320-04-05-.53(2); Tenn. Dep't of Rev., *Business Tax: Retailer vs. Wholesaler*, <http://www.tn.gov/revenue/article/business-tax-retailer-vs.-wholesaler> (last accessed Oct. 12, 2016).

<sup>21</sup> Tenn. Code Ann. § 67-4-709.

<sup>22</sup> Tenn. Code Ann. § 67-4-702(a)(5).

<sup>23</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.15.

<sup>24</sup> Tenn. Dep't of Rev., *Business Tax Guide* 8 (Aug. 2016).

<sup>25</sup> Tenn. Code Ann. § 67-4-709(3).

<sup>26</sup> Tenn. Code Ann. §§ 67-4-702(a)(27), -709.

<sup>27</sup> Tenn. Code Ann. § 67-4-702(a)(17), (27).

<sup>28</sup> Tenn. Code Ann. § 67-4-702(a)(26)(A) ("Wholesale sale' or 'sale at wholesale' means any sale to a retailer for resale.")

<sup>29</sup> Tenn. Code Ann. § 67-4-702(a)(26)(B) ("Wholesale sale' or 'sale at wholesale' includes the sale of industrial materials for future processing, manufacture or conversion into articles of tangible personal property for resale where the industrial materials become a component part of the finished product. This subdivision (a)(25)(B) shall not apply to raw or unprocessed agricultural products.")

<sup>30</sup> Tenn. Code Ann. § 67-4-702(a)(26)(C) ("Wholesale sale' or 'sale at wholesale' includes the sale by a wholesaler of tangible personal property to the state of Tennessee or any county or municipality or subdivision thereof, or the sale to any religious, educational or charitable institution as defined in § 67-6-322.")

<sup>31</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.47(3).

<sup>32</sup> Tenn. Code Ann. § 67-4-702(a)(16), (26).

<sup>33</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.33.

<sup>34</sup> Tenn. Dep't of Rev., *Important Notice No. 16-10* (Sept. 2016).

<sup>35</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.33(1).

<sup>36</sup> Tenn. Comp. R. & Regs. § 1320-04-05-.33(2).

<sup>37</sup> Tenn. Code Ann. § 67-4-702(a)(22)(A)(iv)(a).

<sup>38</sup> Tenn. Code Ann. § 67-4-712(b)(1), (c)(2); see *also* Tenn. Comp. R. & Regs. § 1320-04-05-.28(2).