

## Looking for Clarity on Business Tax Basics in 2022

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In this installment of Bass Tax, Sontag, Jasper, and Guth examine difficult issues regarding calculation of the Tennessee business

tax and explain changes the legislature is expected to make to the tax in 2022.

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Ever since the Department of Revenue took over the Tennessee business tax more than a decade ago, companies doing business in the state, practitioners, and the DOR itself have struggled to understand and apply this unusual tax. What was once a local privilege tax administered and sporadically enforced by cities and counties is now a statewide gross receipts tax

imposed on any business making sales in Tennessee, with the same broad enforcement and audit procedures applicable to all other state taxes.<sup>1</sup> Despite this significant change, the basic framework for the tax, and the controlling statutes and regulations, are materially the same as they were when the tax was far less relevant.<sup>2</sup> This is a problem because the law leaves significant room for interpretation that has resulted in wildly different applications of the tax to similar businesses in different locations across the state. Indeed, the inconsistent enforcement of the business tax was one of the primary reasons the DOR took over the tax in the first place. To this point, however, elevating the tax to the state level has mostly served to highlight the numerous questions and concerns about the business tax.

In fairness, that there are still many unanswered questions about the business tax is not because of a lack of department effort. To the contrary, for the last decade, the DOR, businesses, and practitioners have all worked hard to interpret and apply the tax as reasonably as possible.<sup>3</sup> Unfortunately, and despite those efforts, some of the issues with the business tax are so intertwined with how the controlling statutes are written that additional judicial or legislative action is likely the only way to get these issues

<sup>1</sup> Michael D. Sontag, Stephen J. Jasper, and Robert C. Guth, "Wait, Tennessee Has a Gross-Receipts Tax?" *J. of Multistate Tax. and Incentives* (Jan. 2017).

<sup>2</sup> The Tennessee General Assembly adopted a series of amendments to the business tax statutes that were effective in 2009, 2014, and 2016 as part of the change in administration and enforcement of the tax from a primarily local-level tax to a primarily state-level tax. See Tenn. Pub. Ch. 530 (June 25, 2009); Tenn. Pub. Ch. 313 (Apr. 29, 2013); Tenn. Pub. Ch. 514 (May 20, 2015). Those amendments included some changes to the way the business tax is imposed, but fundamentally, the basic rules that applied before the tax being elevated to the state level remain in effect.

<sup>3</sup> As part of those efforts, the DOR has published a Tennessee Business Tax Manual. It is a comprehensive summary of the business tax laws and the DOR's interpretations of those laws, but it does not definitively resolve many of the open questions at the core of the tax.

properly resolved. Moreover, and just as unfortunate, many of the issues that are still undecided that will likely require legislative or judicial action are fundamental to a basic understanding of how the business tax should be properly calculated and imposed. For example, one of the open issues is how a business should determine whether to apply the retailer rate or the much lower wholesaler rate to calculate its liability. Another open issue is when a company can claim the widely recognized — but often disputed — wholesaler-to-wholesaler exemption from the business tax.

These are core questions that are essential to knowing how a business should calculate and report its business tax liability, but the answers to these questions are still, somehow, open for debate in Tennessee. Thankfully, these two foundational issues are expected to be resolved in 2022, one through the judicial process and one legislatively. This article will discuss these two issues and explain what taxpayers can expect to learn about these business tax basics in 2022.

### What Does a Taxpayer Need to Do to Use the Wholesaler Rate?

One of the most important — and obviously fundamental — components of calculating any tax is determining what rate applies. The rate should rarely be the source of controversy, especially when it is established at a statewide level without any locally adopted optional rates possibly adding confusion.<sup>4</sup> Nevertheless, the rate required to calculate a taxpayer's business tax liability is often difficult to determine and routinely disputed.

The business tax statutes create five classifications of taxpayers, with different rates for each one.<sup>5</sup> The applicable classification — and resulting rate — for each taxpayer is determined

<sup>4</sup>The Tennessee business tax statutes impose the tax as a state tax on gross receipts derived from all taxable activity that takes place in Tennessee and allow municipalities to elect to impose the tax on taxable activities conducted in their jurisdictions. See Tenn. Code Ann. sections 67-4-704, 67-4-705. As a result, the tax is typically imposed twice — once by the state and once by a municipality. The DOR administers and enforces both the state and municipally imposed taxes, and the rates imposed on taxable activities are the same regardless of whether the tax is technically being imposed by the state or a municipality. See Tenn. Code Ann. sections 67-4-703, 67-4-704, 67-4-705, 67-4-708, 67-4-709.

<sup>5</sup>See Tenn. Code Ann. sections 67-4-708, 67-4-709.

based on that taxpayer's "dominant business activity," which is defined as "the business activity that is the major and principal source of taxable gross sales of the business."<sup>6</sup>

In other words, the first step in determining what tax rate applies is to divide all of a taxpayer's sales subject to the tax into one of the five business tax classifications and then decide which classification has the most sales attributed to it.<sup>7</sup> For some taxpayers, this may not be a problem, but for sellers of diverse products or services, this first step can be burdensome and difficult to execute with any degree of confidence. This is especially true because the kinds of sales assigned to the classifications are, in many instances, a hodgepodge of unrelated items that appear to be assigned at random. For example, sales of fresh flowers are assigned to classification 2, but sales of artificial flowers are assigned to classification 3.<sup>8</sup> Just as curiously, sales of clothing, shoes, hats, "and related articles for personal wear and adornment" are assigned to classification 2, but sales of clothes made to order are assigned to classification 3.<sup>9</sup> Finally, and in perhaps the biggest classification issue, sales of tangible personal property not expressly assigned to another classification are assigned to classification 2, but sales of services are assigned to classification 3.<sup>10</sup> Obviously, in today's economy, sales often include both services and tangible

<sup>6</sup>See Tenn. Code Ann. sections 67-4-702, 67-4-708.

<sup>7</sup>As an additional level of difficulty, this analysis is required for each Tennessee business location subject to the tax because, for business tax purposes, each location is generally treated as a separate taxpayer, with its tax liability separately determined based on its activity at that location. See Tennessee Business Tax Manual, p. 43 (Aug. 2021). Sales from outside Tennessee, however, are all treated as being made from one location and are only taxed at the state level. See Tenn. Code Ann. section 67-4-706. Further, when determining a taxpayer's business tax classification based on its dominant business activity at a location, only taxable sales are included in that analysis. As a result, a business location that is primarily engaged in tax-exempt sales can be classified for business tax purposes according to the few taxable sales it makes that are ancillary to its exempt sales. See *Hermitage Memorial Gardens Mausoleum & Memorial Chapel Inc. v. Dunn*, 541 S.W.2d 147, 149 (Tenn. 1976).

<sup>8</sup>Tenn. Code Ann. section 67-4-708(2)(H), (3)(A)(xi).

<sup>9</sup>Tenn. Code Ann. section 67-4-708(2)(B), (3)(A)(ii).

<sup>10</sup>Tenn. Code Ann. section 67-4-708(2)(F), (3)(C).

personal property, and distinguishing between the two is not easy.<sup>11</sup>

But even ignoring the potential pitfalls in properly identifying a taxpayer's classification, the applicable tax rate is still not free from doubt because, in most classifications, different rates apply depending on whether the taxpayer is a wholesaler or a retailer.<sup>12</sup> And the difference is significant. In the two most commonly applicable classifications — classifications 2 and 3 — the rate for retailers is approximately four times the rate for wholesalers.<sup>13</sup> As a result, determining whether a taxpayer is a wholesaler or a retailer is critically important to calculating its business tax liability, but again, making that determination can be difficult for many taxpayers.

Under the business tax statutes, a wholesaler is defined as a business that makes more than 50 percent of its taxable gross sales as wholesale sales, and a retailer is defined as a business that makes more than 50 percent of its taxable gross sales as retail sales.<sup>14</sup> Consequently, to determine a taxpayer's status, each of its sales must be identified as being either wholesale or retail. For these purposes, wholesale sales are "any sale to a retailer for resale," including sales of materials that become a component part of a finished product that the purchaser manufactures and sells.<sup>15</sup> In contrast — and much less helpfully — retail sales are defined as "any sale other than a wholesale sale."<sup>16</sup>

Under these definitions, for a taxpayer to determine whether it is a wholesaler or a retailer and, based on that determination, what business tax rate applies, the taxpayer must know what its customers do with the products or services it sells. If more than 50 percent of its sales are made to customers that resell the products or services,

either as is or after being manufactured into a new product, the taxpayer is a wholesaler entitled to use the lower rate. However, if more than 50 percent of its sales are made to customers that use the products or services themselves, the taxpayer is a retailer and must pay the higher rate. Unfortunately, customers are often either unwilling or unable to provide their vendors with the kind of detailed information needed for taxpayers to make this determination that is essential to calculating their business tax liability.

Those were exactly the circumstances that gave rise to the *Bearing Distributors Inc.* (BDI) case recently argued before the Tennessee Court of Appeals.<sup>17</sup> The taxpayer, BDI, sold a variety of industrial products, including bearings, motors, and tools.<sup>18</sup> Most of BDI's customers were manufacturers that either used the BDI products as part of their manufacturing processes or incorporated them as component parts of the products they manufactured and sold to their customers.<sup>19</sup> Despite these different uses, BDI treated its sales to all manufacturer customers as sales for resale and — because sales to those customers accounted for most of its sales — reported its business tax using the wholesaler rate.<sup>20</sup> In other words, BDI presumed its customers resold the products as component parts of their own products, rather than using them to manufacture those products.

On audit, the DOR disagreed with this presumption and applied the retailer rate to all of BDI's sales.<sup>21</sup> Notably, the auditor did not justify this determination by identifying or providing any specific data to establish, or even suggest, that BDI's wholesaling presumption was incorrect. Instead, the auditor put the burden on BDI, saying that she was "unable to verify the accuracy of the taxpayer's claim" that its sales were wholesale sales.<sup>22</sup> As a result, the auditor rejected BDI's use of the wholesaler rate and imposed an assessment of

<sup>11</sup> See, e.g., *Auto Glass Co. of Memphis Inc. v. Gerregano*, 596 S.W.3d 257, 264 (Tenn. Ct. App. 2019) (resolving a dispute regarding the proper classification of a taxpayer that sold automobile glass replacement services by finding it was primarily in the business of selling tangible personal property because its gross receipts from sales of glass in connection with its services were greater than the gross receipts from sales of the replacement services).

<sup>12</sup> Tenn. Code Ann. section 67-4-709.

<sup>13</sup> *Id.*

<sup>14</sup> Tenn. Code Ann. section 67-4-702(a)(17), (27).

<sup>15</sup> Tenn. Code Ann. section 67-4-702(a)(26).

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

<sup>17</sup> *Bearing Distributors Inc. v. Gerregano*, No. M2020-01075-COA-R3-CV (Tenn. Ct. App.).

<sup>18</sup> *Bearing Distributors Inc. v. Gerregano*, No. 17-1261-IV, at 1 (Tenn. Ch. 20th Dist. July 14, 2020).

<sup>19</sup> *Id.* at 1-2.

<sup>20</sup> *Id.* at 2.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

additional business tax calculated at the higher retailer rate for every year in the audit period.<sup>23</sup>

BDI challenged the assessment. In its arguments to the trial court, BDI claimed the assessment imposed an “impossible burden” on BDI to demonstrate that it qualified as a wholesaler under the 50 percent test required by the business tax statutes.<sup>24</sup> According to BDI, making that determination would require it “to obtain and analyze customer use information for each of multiple millions of products sold to its manufacturing customers,” which was information unavailable to BDI, even if these records existed.<sup>25</sup> In response, the DOR argued that BDI could simply rely on “a variety of already-available documents” and could classify sales on a customer-by-customer basis, rather than an item-by-item basis.<sup>26</sup> The DOR claimed BDI could simply treat all sales made to customers that provided resale certificates for sales tax purposes as wholesale sales for business tax purposes and make the 50 percent analysis on that basis.<sup>27</sup>

Ruling on the parties’ cross-motions for summary judgment, the trial court agreed with the DOR, finding it would not be impossible for BDI to gather the information necessary to demonstrate that it meets the more-than-50-percent-wholesale-sales threshold.<sup>28</sup> The court wrote it is “not necessary for a taxpayer, like BDI, to make the wholesale v. retail determination on a sale-by-sale basis.”<sup>29</sup> Instead, a taxpayer “can support its claim of greater than 50 percent wholesale sales with a variety of already-available documents and that taxpayer can proceed on a customer-by-customer, rather than item-by-item, basis.”<sup>30</sup> Applying this test, if more than 50 percent of BDI’s sales were made to customers

that provided resale certificates, BDI could file at the wholesaler rate.

BDI appealed to the Tennessee Court of Appeals, which held oral arguments in September. A decision is expected in early 2022. If the court upholds the trial court’s decision and analysis, BDI’s loss could be a significant gain for other taxpayers because a taxpayer can apply a “rough justice” approach to determine if it is entitled to use the lower wholesaler rate. Rather than conducting a sale-by-sale analysis that is often difficult or impossible to apply because of the information that is — or, more often, is not — available to taxpayers, a decision upholding the trial court’s conclusions would allow a taxpayer to simply rely on a customer’s sales tax resale certificate to treat all sales to that customer as wholesale sales for business tax purposes. This dramatically simplifies the process because taxpayers are already likely receiving resale certificates from their customers and because it eliminates the need to determine what the customers do with the products or services on a sale-by-sale basis. Taxpayers can simply rely on the certificates provided by their customers, classify all sales to a customer the same way based on the certificate provided, and file accordingly.

It must be said that this customer-by-customer approach endorsed by the trial court is potentially inconsistent with the technical requirements of the business tax statutes. Still, it is a much simpler approach and, in most circumstances, would likely reach the same result as a sale-by-sale analysis. The DOR regularly relies on statistical sampling in sales and use tax audits, and the approach adopted in *Bearing Distributors* can be seen as an extension of that approach, allowing a conclusion to be reached based on a more general review of the underlying data. Further, because the DOR argued for this simplified approach and appears to use a customer-by-customer approach with other taxpayers, using that method to determine whether a taxpayer is a wholesaler entitled to use the wholesaler rate arguably falls within the DOR’s discretionary authority to interpret and impose the business tax.<sup>31</sup> At the very least, given the DOR’s arguments in *Bearing*

<sup>23</sup> *Id.* Upon administrative review, the DOR reversed the auditor’s decision regarding one of BDI’s Tennessee locations but upheld the use of the retailer rate to calculate business tax liability for its other locations. See *id.* at 2-3.

<sup>24</sup> *Id.* at 6.

<sup>25</sup> *Id.* at 14.

<sup>26</sup> *Id.* at 6.

<sup>27</sup> *Id.* at 15-16.

<sup>28</sup> *Id.* at 16.

<sup>29</sup> *Id.* at 16-17.

<sup>30</sup> *Id.* at 17.

<sup>31</sup> See Tenn. Code Ann. section 67-1-102.

*Distributors*, taxpayers should be able to rely on the simplified approach adopted by the BDI trial court until the DOR announces a different policy or the appeals court issues a decision that expressly rejects that approach.<sup>32</sup>

For taxpayers everywhere — other than BDI — it would be best for the court of appeals to uphold the trial court's decision or, at most, reverse the decision without rejecting the approach adopted in that decision. The DOR's method adopted by the trial court in *Bearing Distributors* offers taxpayers a relatively straightforward option for determining whether to calculate their business tax liability using the wholesaler or retailer rate. That determination must be made by every taxpayer responsible for reporting and paying the tax. Making that basic determination should not be a burden and should not inject additional uncertainty into an already confusing tax.

### When Does the Wholesaler-to-Wholesaler Exemption Apply?

As suggested by the discussion above, one of the more curious aspects of the Tennessee business tax is that it intentionally imposes the tax on business inputs by making both wholesalers and retailers subject to the tax. To prevent this duplicative taxation from extending too far up the distribution chain, there is an exemption for sales for resale made from one wholesaler to another wholesaler. Whether this was, in fact, a valid exemption from the business tax was previously disputed, but it is now well-settled in Tennessee that sales for resale from one wholesaler to another are exempt from the tax.<sup>33</sup>

That is the good news. The bad news is that whether the wholesaler-to-wholesaler exemption applies to some transactions is one of the most, if not the most, commonly disputed business tax issues.<sup>34</sup> The reason is that for the exemption to apply, the taxpayer must be a wholesaler, and the

taxpayer's customer must also be a wholesaler. As a result, the problems of proof discussed above are even more exacerbated here.

Again, to qualify as a wholesaler, a business must make more than 50 percent of its taxable sales to customers that resell the products, rather than to end users. Consequently, to prove that the wholesaler-to-wholesaler exemption applies, a taxpayer must not only know what its customers do with the products sold to them, it must also know what those customers' customers do with these products.<sup>35</sup> Obviously, this kind of detailed information about what their own customers do with the products they sell is not information a taxpayer's customers routinely or willingly provide, leaving taxpayers stuck making educated guesses based on their own knowledge of the customers or industry. These guesses can be pretty reliable because they are often based on a taxpayer's knowledge about the customer, how the industry functions, or the nature of the products involved. Nevertheless, in many instances, taxpayers have relied on that understanding of the customer or industry to claim the wholesaler-to-wholesaler exemption only to have an auditor reject that exemption for insufficient proof. When that happens, taxpayers are left in the difficult position of challenging an assessment without access to the information needed to prove it was properly taken.

Legislation is expected to be proposed in the upcoming session of the Tennessee General Assembly to address this issue. If adopted, the legislation will create a certificate system, like the resale certificates used for sales tax purposes, that allows taxpayers to rely on customer representations that the customers are wholesalers for business tax purposes. Under the proposed legislation, each taxpayer that files a business tax return using a wholesaler rate will receive a DOR certificate that can be provided to sellers in the same way that purchasers currently provide resale certificates for sales tax purposes. Thereafter, any seller that receives a wholesaler certificate from a customer is entitled to treat sales

<sup>32</sup> See Tenn. Code Ann. section 67-1-108.

<sup>33</sup> See Tenn. Comp. R. & Regs. 1320 04 05-.47(3); see also *Pfizer Inc. v. Johnson*, 2006 WL 163190 (Tenn. Ct. App. 2006).

<sup>34</sup> See, e.g., *Eisai Inc. v. Gerregano*, No. 19-805-IV (Tenn. Ch. 20th Dist. Nov. 2, 2021); *Regeneron Healthcare Solutions Inc. v. Gerregano*, No. 21-0079-IV (Tenn. Ch. 20th Dist.); *Regeneron Pharmaceuticals Inc. v. Gerregano*, No. 21-0207-II (Tenn. Ch. 20th Dist.).

<sup>35</sup> Because a taxpayer's customer's status as a wholesaler is determined based on all its sales, a taxpayer must determine whether its customer's customers resell or use all the products the taxpayer's customer sells, not just those products sold to the customer by the taxpayer.

for resale made to that customer as exempt from the business tax.

To be certain, this legislation is not guaranteed to be adopted. The entire legislative process is still in its early days, and the Tennessee General Assembly is not set to reconvene until January. Still, there is reason for optimism. If the bill is adopted, it will dramatically decrease the burden on taxpayers to claim the wholesaler-to-wholesaler exemption. It will benefit both taxpayers and the DOR by making the wholesaler-to-wholesaler exemption easier and more efficient to administer and, in doing so, significantly reduce the likelihood of disputes regarding the exemption. Perhaps most remarkably, the legislation will do all of this without expanding the scope of the exemption in any meaningful way. Instead, it will simply bring clarity to one of the most troublesome aspects of the business tax law and provide a more easily navigated path forward in 2022 and beyond.

### Conclusion

There is still a lot of work to be done to help make the Tennessee business tax easier for taxpayers to apply and for the DOR to administer and enforce. If everything goes as expected, there will be real developments on that front in 2022, helping taxpayers and the DOR better understand basic concepts like what rate to use to calculate liability and when the wholesaler-to-wholesaler exemption applies. Once these fundamental issues are resolved, other issues will hopefully be addressed in subsequent years because, unless the business tax is going to be eliminated in its entirety, it is essential to resolve the gaps and questions baked into the tax itself. For now, at least, taxpayers can look forward to the possibility of a little more clarity in the coming year. ■

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