TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 99-32

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 Tennessee's excise and business taxes to a [FOREIGN COUNTRY A] corporate subsidiary of a [FOREIGN COUNTRY B] parent corporation where the [FOREIGN COUNTRY A] subsidiary has no United States subsidiary, employees or facilities in Tennessee, but does sell products which are stored in a Tennessee warehouse that is located in a free trade zone.

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 revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[THE TAXPAYER] is a [FOREIGN COUNTRY A] corporate subsidiary of a [FOREIGN COUNTRY B] corporation. [THE TAXPAYER] is domiciled in [FOREIGN COUNTRY A] and does not have a United States subsidiary. [THE TAXPAYER] will not have employees in Tennessee, a business location in Tennessee or any other Tennessee connections. [THE TAXPAYER] does, however, have manufacturing customers in Tennessee, [STATE OTHER THAN TENNESSEE], [STATE OTHER THAN TENNESSEE] and [FOREIGN COUNTRY C] to which it sells [PRODUCTS]. One or more of the manufacturers desire to have a "just in time" inventory delivery system. [THE TAXPAYER] is therefore contemplating the following:

[THE TAXPAYER] will retain the services of an independent warehouseman to handle its products. The warehouseman will be an independent agent acting for [THE TAXPAYER] and will not be an employee of [THE TAXPAYER]. The warehouseman will store the [TAXPAYER] products at a facility that has been leased by the warehouseman and which is located in a free trade zone in Tennessee. A portion of the leased facility is currently being used to store products for other foreign corporations that have contracted with the warehouseman.

[PRODUCTS] owned by [THE TAXPAYER] will be shipped from [FOREIGN COUNTRY A], [FOREIGN COUNTRY D], [FOREIGN COUNTRY E], [FOREIGN COUNTRY F] and [FOREIGN COUNTRY G] to the warehouse in Tennessee. Those [PRODUCTS] will then be shipped directly from the warehouse to customers in Tennessee, [STATE OTHER THAN TENNESSEE], [STATE OTHER THAN TENNESSEE] and [FOREIGN COUNTRY C]. The customers will communicate with [THE TAXPAYER], in [FOREIGN COUNTRY A], regarding its product needs. The warehouseman will remove the product from the warehouse, ship the product to the customer and inform [THE TAXPAYER] of the transaction for final invoicing. A third party customs broker will handle the paperwork to clear the [PRODUCTS] out of the warehouse since the warehouse is in a free trade zone. Title will pass within the free trade zone as soon as the product is removed from the [TAXPAYER] designated shelves. At the time that the product is shipped out of the free trade zone to customers in [STATE OTHER THAN TENNESSEE], [STATE OTHER THAN TENNESSEE] and [FOREIGN COUNTRY C], the products are no longer owned by [THE TAXPAYER].

As a foreign[1] corporation, [THE TAXPAYER] will be required to file form 1120-F with the Internal Revenue Service. As a [FOREIGN COUNTRY A] corporation, however, [THE TAXPAYER'S] liability for federal income taxation is proscribed in accordance with the terms of a [YEAR] Income Tax Treaty[2] ("Treaty") between [FOREIGN COUNTRY A] and the United States. Under the terms of the Treaty, federal income taxes arising from the business profits of [THE TAXPAYER] that would otherwise be taxable to the United States, are not taxable unless [THE TAXPAYER] carries on

[1] For purposes of this ruling, the term "foreign" will be used to describe a corporation that is domiciled in a country other than the United States.
[2] [FN]

business through a permanent establishment[3] located in the United States. Due to the fact that [THE TAXPAYER] will not have a permanent establishment as that term is defined under the Treaty, the United States will not have jurisdiction to impose its federal income tax on [THE TAXPAYER]. [THE TAXPAYER] will, therefore, have zero federal taxable income reported on its 1120-F.

ISSUE

1. Under the facts given, is [THE TAXPAYER] subject to Tennessee excise taxes?

2. Is [THE TAXPAYER] subject to Tennessee business taxes?

RULING

1. No.

2. Yes.

ANALYSIS

1. Tennessee's corporate franchise and excise taxes are taxes imposed upon the privilege of doing business in corporate form and the privilege of exercising the corporate franchise in Tennessee. *Memphis Bank & Trust Co. v. Garner*, 624 S.W.2d 551 (Tenn. 1981). Public Chapter 406 of the Public Acts of 1999 expands application of the franchise, excise taxes to other types of business entities, but excludes general partnerships and sole proprietorships.[4] The taxes are imposed to compensate the state for the protection of the taxpayer's local activities and as compensation for the benefits received from doing business in Tennessee. *Mid-Valley Pipeline Co. v. King*, 431 S.W.2d 277, 280 (Tenn. 1968). The taxes are imposed on different tax bases. *First American Nat'l Bank v. Olsen*, 751 S.W.2d 417 (Tenn. 1987). The franchise tax has as its base the taxpayer's net worth with the minimum measure being the actual value of the property owned, or property used, in Tennessee. T.C.A. §§ 67-4-2106, 67-4-2108. The

[3] The Treaty defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on and includes the following: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop; and (f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. The term "permanent establishment" shall be deemed not to include: (a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or collecting information for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; (f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraph (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

[4] See, T.C.A. §§ 67-4-2004(16), 67-4-2005, 67-4-2007 and 67-4-2105.

excise tax, on the other hand, is based upon a taxpayer's net earnings from business done in Tennessee. T.C.A. § 67-4-2007.

With certain exceptions, Tennessee imposes its franchise and excise taxes upon all persons[5] doing for profit business in Tennessee. T.C.A. §§ 67-4-2105 and 67-4-2005. Therefore, absent a federal law or a constitutional prohibition, [THE TAXPAYER], like every other person who does business in Tennessee, will be required to pay Tennessee franchise and excise taxes.[6]

In [YEAR], [FOREIGN COUNTRY A] and the United States entered into an income tax treaty ("Treaty"). By its terms, the Treaty applies only to the governments of [FOREIGN COUNTRY A] and the United States. *Id.* at art.3, ¶ 1. Under certain factual circumstances, the Treaty prohibits federal income taxation of the business profits of a [FOREIGN COUNTRY A] corporation doing business in United States. Specifically, the Treaty provides as follows:

> "[t]he profits of an enterprise of a Contracting State[7] shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."

Id. at art. 7, ¶ 1.

The term "permanent establishment" is not deemed to include the following:

> (a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise; or
>
> (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery.

Id. at art. 5, ¶ 1.

Furthermore, the Treaty provides that:

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[5] The term "person" is defined broadly to include every corporation, subchapter S corporation, limited liability entities, limited partnerships, cooperatives, joint-stock associations, business trusts, regulated investment companies, real estate investment trusts, state-chartered or national banks, state- or federally-chartered savings and loan associations and any other organization or entity engaged in business; but does not include sole proprietorships or general partnerships.

[6] [THE TAXPAYER] concedes that it will be subject to Tennessee's franchise tax so the remainder of this ruling will address the applicability of Tennessee's excise tax to [THE TAXPAYER].

[7] The term "Contracting State" refers to either the United States or the [FOREIGN COUNTRY A] governments who are the parties to the treaty and not to the individual states or political subdivisions thereof.

> [a]n enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as such.

Id. at art. 5, ¶ 6.

For the purposes of this ruling, the department assumes as correct [THE TAXPAYER'S] assertion that the Treaty prohibits the United States from imposing federal income taxes upon [THE TAXPAYER'S] business profits. Whether Tennessee can tax [THE TAXPAYER'S] business profits, however, is another question because the Treaty does not, by its specifically expressed terms, apply to Tennessee or any of the other individual states of the United States. Of course, the State of Tennessee is bound by treaties between the federal government and other countries to the extent that they affect state taxes administered by the Tennessee Department of Revenue. Since the Treaty applies only to the governments of the United States and [FOREIGN COUNTRY A], however, there must be either some other prohibition against taxation, either in the form of a federal law or a constitutional prohibition, in order to relieve [THE TAXPAYER] of its obligation to pay Tennessee's excise tax on its business profits attributable to its activities in Tennessee.

It does not appear that there is any federal law that would preclude Tennessee from imposing the excise tax and the taxpayer has cited no such law. Given the fact that there is a tax treaty in place, however, the Commerce Clause must be analyzed to determine if Tennessee's excise tax would be in contravention of that constitutional clause.

The Commerce Clause gives congress the power to regulate commerce with foreign nations and among the several states.[8] It has long been understood, as well, to "provide protection from state legislation inimical to the national commerce [even] where congress has not acted ..." *Southern Pacific Co. v. Arizona ex rel. Sullivan*, 325 U.S. 761, 769, 65 S.Ct. 1515, 1520, 89 L.Ed. 734 (1938) (Commerce Clause "by its own force prohibits discrimination against interstate commerce").[9] The Clause, however, "does not shield interstate (or foreign) commerce from its fair share of the state tax burden." *Department of Revenue of Wash. v. Association of Wash. Stevedoring Cos*., 435 U.S. 734, 750, 98 S.Ct. 1388, 1399, 55 L.Ed.2d 682 (1978). Indeed, it was "not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business." *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 254, 58 S.Ct. 546, 548, 82 L.Ed. 823 (1938).

As the power to regulate commerce is vested solely in the congress, the individual states must not take any action in contravention of congress' power or such action will be held

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[8] U.S. Constitution Art. 1, § 8 cl. 3.

[9] This self-executing aspect of the Commerce Clause is known as the "dormant" or "negative" Commerce Clause.

to be unconstitutional and therefore invalid. With foreign commerce, the State's power to levy taxes is constrained because of "the special need for federal uniformity." *Wardair Canada Inc. v. Florida Dept. of Revenue*, 477 U.S. 1, 8, 106 S.Ct. 2369, 2373, 91 L.Ed.2d 1 (1986), as "the people of the United States act through a single government with unified and national power". *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 99 S.Ct 1813. A state tax that affects foreign commerce raises concerns about the risk of multiple taxation and the federal governments ability to speak with one voice when regulating commercial relations with foreign governments. *Id.* at 449.

With respect to the constitutionality of a state's ability to impose taxes upon interstate commerce, the United States Supreme Court has established four (4) principals that must be met before a state may impose such taxes. See, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 97 S.Ct. 1669 (1977). In the unique context of foreign commerce, the courts have imposed two (2) additional tests that must be satisfied before state taxation of a foreign entity will be constitutional. See, *Japan Line*, supra. In *Complete Auto*, supra, the court held that a state tax would not be deemed to burden interstate commerce if:

> (1) the activity subject to the tax had substantial nexus with the state;
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> (2) the tax was fairly apportioned;
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> (3) the tax did not discriminate against interstate commerce; and
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> (4) the tax was fairly related to services that the state provided.

In *Japan Line*, supra, the court set forth two additional factors that are to be applied when a state tax threatens to burden foreign commerce. These are:

> (1) there must be no substantial risk of double taxation; and
>
> (2) the tax must not prohibit the United States from speaking with "one voice" when regulating commerce with foreign nations.

If these principles are not met, the state's tax is considered a burden upon foreign commerce and is therefore unconstitutional. See, *Japan Line*, supra at 444-451. Therefore, to determine whether Tennessee could impose its excise tax on [THE TAXPAYER'S] proposed business activities in Tennessee, one must apply the tests set forth in *Complete Auto*, supra, and *Japan Line*, supra.

I. Application of Tennessee's Excise Tax to the Complete Auto Factors

In applying the four factors of *Complete Auto* to [THE TAXPAYER'S] proposed activities in Tennessee, it appears that Tennessee's excise tax would survive constitutional scrutiny.

1) Nexus - Tennessee has long held that business done through public or private warehouses is taxable. See, *R.J. Reynolds Tobacco Co. v. Carson*, 213 S.W.2d 45 (Tenn. 1948) (which held that an out of state corporation that ships it products to, and stores its products in, a Tennessee warehouse for later distribution to its customers in Tennessee and elsewhere, is subject to Tennessee franchise and excise tax liability). See also, *Cole Brothers Circus v. Huddleston*, 1993 Tenn. App. LEXIS 386 (holding that nexus is satisfied by a taxpayer's physical presence in Tennessee). [THE TAXPAYER'S] activity and presence in Tennessee would clearly create a substantial nexus with Tennessee. As such, with respect to the imposition of Tennessee's excise tax upon [THE TAXPAYER], the first prong of the *Complete Auto* test is satisfied.

2) Fair Apportionment - Tennessee, like twenty-four (24) other states, imposes taxes using the apportionment method embodied in the Uniform Division of Income for Tax Purposes Act ("UDITPA"). See, *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460 (Tenn. Ct. App. 1996). Under the apportionment method, all of a multistate corporation's business income is determined and then apportioned pro rata among the states in which the corporation does business. *Id.* at 685. Each state is permitted to tax that portion of the corporation's income that is proportional to the portion of its business done in that state. *Id.* at 685 (citing *Holiday Inns, Inc. v. Olsen*, 692 S.W.2d at 852; 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* p8.5 (2nd ed. 1993)). For the excise tax, the UDITPA formula apportions taxes to Tennessee by considering the taxpayer's Tennessee property, payroll and receipts versus the taxpayer's property, payroll and receipts outside of Tennessee. See, T.C.A. §§ 67-4-2012 and 67-4-2111.

Tennessee's excise tax would be fairly apportioned as the tax would be based on [THE TAXPAYER'S] Tennessee business profits and not on income generated or activities carried on outside the state's borders. Under UDITPA, the income attributed to Tennessee would be in proportion to the business [THE TAXPAYER] transacted in Tennessee and if this method of apportionment were applied in every jurisdiction in which [THE TAXPAYER] does business it would result in no more than all of the unitary business income being taxed.[10] Therefore, the second prong of the *Complete Auto* test is satisfied.

3) Discrimination Against Interstate Commerce - If [THE TAXPAYER] does business in Tennessee, it must share the common burdens of government that benefit both intra- and inter-state business. See, *Department of Revenue of Wash. v. Association of Wash. Stevedoring Cos*., supra at 750. Tennessee's excise tax would not discriminate against interstate commerce because it would not place any greater burden on interstate

[10] Factors that the United States Supreme Court determined in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 1003 S.Ct. 2933, 77 L.Ed.2d 545 (1983) would result in fair apportionment.

commerce than the taxes place upon intrastate commerce of like character. In other words, Tennessee's excise tax would not be discriminatory against [THE TAXPAYER] because [THE TAXPAYER], as a foreign corporation doing business in Tennessee, would be taxed the same as a Tennessee corporation doing business in Tennessee. Therefore, the third prong of the *Complete Auto* test is satisfied.

4) Tax Fairly Related to Services Provided - In *Complete Auto*, the fourth prong of the test requires only that the measure of the tax be reasonably related to the extent of the taxpayer's contact with the state. *Complete Auto*, supra at 622. The general government services that facilitate a taxpayer's business are sufficient to establish the state's taxing authority. *Cole Brothers Circus*, supra at 393. As [THE TAXPAYER] will be physically present in Tennessee, it will, among other things, be entitled to fire and police protection, access to Tennessee courts and will enjoy the privilege of transporting its products over Tennessee's streets and highways. In short, Tennessee will bestow powers, privileges and benefits upon [THE TAXPAYER] that will facilitate its business operations in Tennessee. The excise tax that would be imposed upon [THE TAXPAYER] as a result of its activities and presence in Tennessee would be fairly related to the services that Tennessee provides to [THE TAXPAYER] and as such the tax would pass the fourth prong of the *Complete Auto* test.

II. <u>Application of Tennessee's Excise Tax to the Japan Line Factors</u>

Tennessee's excise tax, when subjected to the two additional *Japan Line* tests, will not survive constitutional scrutiny under the Commerce Clause.

First, Tennessee's excise tax, which is a privilege tax based upon an entity's net earnings from business done in Tennessee, will result in a substantial risk of international double taxation. Like the foreign corporation in *Japan Line*, [THE TAXPAYER] is subject to a tax treaty that gives [THE TAXPAYER'S] country of domicile the exclusive jurisdiction to impose its tax laws. While a tax treaty does not necessarily pre-empt a state from imposing a unitary tax on a domestic subsidiary where the tax calculation includes income from entities formed in foreign nations[11], [THE TAXPAYER] will not have a domestic subsidiary. Furthermore, [THE TAXPAYER] will not have a permanent establishment in the United States and will not be subject to paying federal income tax.

The Treaty between [FOREIGN COUNTRY A] and the United States speaks directly to the subject of taxation of business income and specifies that only [FOREIGN COUNTRY A] can tax the business income of [THE TAXPAYER] so long as [THE TAXPAYER] does not have a permanent establishment in the United States. Since Tennessee's excise tax is a tax with a base consisting of an entities' business earnings, the imposition of the tax in light of the Treaty prohibition would result in a substantial risk of that business income being taxed twice, once by [FOREIGN COUNTRY A] and once by Tennessee.

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[11] *Barclay's Bank, PLC v. Franchise Board of California*, 512 U.S. 298, 114 S.Ct. 2268, 129 L.Ed. 244 (1944).

Secondly, imposition of Tennessee's excise tax on [THE TAXPAYER] would prohibit the United States from speaking with "one voice" when regulating commerce with [FOREIGN COUNTRY A]. The Treaty specifies that the profits of a [FOREIGN COUNTRY A] company shall be taxable only in [FOREIGN COUNTRY A] unless the [FOREIGN COUNTRY A] company carries on business in the United States through a permanent establishment as defined in the Treaty. As discussed above, [THE TAXPAYER'S] activities in Tennessee will not be conducted through a permanent establishment. Therefore, since the United States has spoken as to the taxation of the business profits of a [FOREIGN COUNTRY A] company, any attempt by Tennessee to impose a tax on [THE TAXPAYER'S] business profits will impair the Federal government's ability to speak with "one voice" with respect to taxation of a foreign entity, in this case, a [FOREIGN COUNTRY A] corporation. Similar to the court's reasoning in *Japan Line*, the United States could be subject to retaliation from [FOREIGN COUNTRY A] if Tennessee is allowed to impose taxes on the business profits of [FOREIGN COUNTRY A] Companies in derogation of the Treaty.

2. The Business Tax Act, T.C.A. § 67-4-701 *et seq.*, is a component of Tennessee's privilege taxes. The tax is on the privilege of engaging in business in Tennessee. *Westinghouse Electric Corp. v. King*, 678 S.W.2d 19 (Tenn. 1984). It allows counties and incorporated municipalities to tax the privilege of engaging in any of the business activities enumerated in the Act, where such business activity is carried on in that locality. T.C.A. § 67-4-704(a); *Westinghouse Electric Corp.*, 678 S.W.2d at 23. The express intent of the legislature is to impose the business tax, within the framework of the Business Tax Act, to the full extent permitted under the constitutions of the United States and the State of Tennessee. T.C.A. § 67-4-701(c).

T.C.A. § 67-4-708 classifies the businesses which are subject to the tax. Classification 2 includes:

> Each person engaged in the business of making sales of the following:
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> (F) Tangible personal property not specifically enumerated or described elsewhere in this part[.]

[THE TAXPAYER] will engage in the business of selling [PRODUCTS] in Tennessee. The [PRODUCTS] will be shipped from overseas locations to the warehouse in Tennessee. When a product is ordered, [THE TAXPAYER] will have its independent agent remove the item from [THE TAXPAYER'S] designated shelves. Title will pass to the customer within the warehouse as soon as the product is removed from the shelf. The product is then shipped to the customer located inside or outside Tennessee.

Under these facts, [THE TAXPAYER] is subject to business tax in the locality where these sales are made, unless an exemption applies or imposition of the tax is prohibited by the constitutions of the United States or the State of Tennessee.

[THE TAXPAYER] contends that T.C.A. § 67-5-220 in conjunction with Article II, § 28 of the Tennessee Constitution provides an exemption from business tax under the circumstances at issue. As discussed in the facts, the warehouse in which the products are stored and in which the sales take place is located within a free trade zone authorized by T.C.A. §§ 7-85-101 et seq. and 19 U.S.C. §§ 81a et seq. T.C.A. § 67-5-220 provides:

> Tangible personal property imported from outside of the United States and held in a foreign trade zone or foreign trade subzone, as defined in title 7, chapter 85, for the purpose of sale, manufacture, processing, assembly, grading, cleaning, mixing or display shall be exempt from Tennessee ad valorem taxation while held in the foreign trade zone or subzone and thereafter, if the property is then exported from the foreign trade zone or subzone directly to a location outside of Tennessee.

Under this provision, the items held by [THE TAXPAYER] for sale are exempt from property tax as long as they remain in the free trade zone. Article II, § 28 of the Tennessee Constitution provides, in pertinent part:

> In accordance with the following provisions, all property real, personal or mixed shall be subject to taxation. . . .
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> The Legislature shall have the power to tax merchants, peddlers, and privileges, in such manner as they may from time to time direct, and the Legislature may levy a gross receipts tax on merchants and businesses in lieu of ad valorem taxes on the inventories of merchandise held by such merchants and businesses for sale or exchange.

[THE TAXPAYER] argues that property which is exempt from ad valorem tax under Title 67, Chapter 5, is necessarily also exempt from business tax under Title 67, Chapter 4 because the business tax is levied in lieu of ad valorem tax on inventories. Thus, [THE TAXPAYER] asserts, you cannot have an imposition of business tax where there would be no imposition of an ad valorem tax.

[THE TAXPAYER'S] position, however, is not correct. In several decisions, the Tennessee Court of Appeals has held that the purpose of the constitutional language at issue is to allow a business to pay only one tax instead of two on its inventory of goods, that one tax being based on gross receipts rather than ad valorem. *Dixie Rents, Inc. v. City of Memphis*, 594 S.W.2d 397, 400 (Tenn. Ct. App. 1979) *cert. denied* (1980); *IBM Credit Corporation v. County of Hamilton*, 830 S.W.2d 77, 78 (Tenn. Ct. App. 1992) *perm. app. denied*; *Eastman Kodak Company v. Garrett*, 671 S.W.2d 474, 476 (Tenn. Ct. App. 1983) *perm. app. denied* (1984); *Coble Systems, Inc. v. Armstrong*, 660 S.W.2d 802, 806 (Tenn. Ct. App. 1983) *perm. app. denied*.

The Court in *Dixie Rents* examined the evolution of the Business Tax Act, the Property Tax Act, and the Limited Constitutional Convention of 1971 which led to the amendment of Article II, § 28. As explained by the Court, the Business Tax Act was passed in 1971 with the intent of exempting those paying business tax from paying ad valorem tax on their inventory. *Dixie Rents, Inc.*, 594 S.W.2d at 399. However, under the Tennessee Constitution there was no authority for removing the ad valorem tax on inventories. *Id*. Consequently, the Court in *Metropolitan Government of Nashville & Davidson County v. Tidwell*, No. A-1081 (Davidson County Chancery Court, final decree February 29, 1972), elided the exemption from property tax, which resulted in merchants being taxed under both the Business Tax Act and the Property Tax Act. *Dixie Rents, Inc.*, 594 S.W.2d at 399. In response to this constitutional problem, the Limited Constitutional Convention of 1971 met and adopted the language at issue. *Id*. The Court in *Dixie Rents* held that the intent of the amendment was to allow the Legislature to exempt merchants from paying ad valorem tax on inventory. *Id*. at 400. The business tax was already in place. The language was needed to allow the legislature to exempt business inventory from the ad valorem tax.

Thus, the intent of the constitutional provision is to prevent double taxation on merchant's inventories. *Eastman Kodak Company*, 671 S.W.2d at 476. It does not necessarily follow that a company whose goods are exempt from property tax is likewise exempt from tax on the privilege of carrying on its business, as there is no issue of double taxation. In fact, many companies that are subject to business tax, such as service providers, have no inventory that would be subject to property tax. The gross receipts tax on these businesses is not "in lieu of" a tax on inventories as [THE TAXPAYER] construes that language.

Finally, the Foreign Trade Zone Act was enacted in 1981. T.C.A. § 67-5-220 was subsequently enacted in 1983. Both enactments took place well after the business tax was established. Had the legislature intended to exempt from business tax companies carrying on business in a free trade zone, it could have stated that intent. "Tax exemption statutes are to be construed against the taxpayer and will not be implied. . . . Every presumption is against exemption, and any well founded doubt defeats a claimed exemption. . . .The burden is upon the taxpayer to establish a claimed exemption." *Hutton v. Johnson*, 956 S.W.2d 484, 488 (Tenn. 1997)(quoting *American Cyanamid Company v. Huddleston*, 908 S.W.2d 396, 400 (Tenn. Ct. App. 1995). Therefore, [THE TAXPAYER'S] business is not exempt from business tax on the basis of T.C.A. § 67-5-220.

[THE TAXPAYER'S] business is also not exempt from business tax under the Foreign Trade Zone Act, T.C.A. §§ 7-85-101 et seq., or the provisions of 19 U.S.C. §§ 81a et seq. Under those provisions, subject to various restrictions, foreign and domestic merchandise can be brought into the zone without being subject to the customs laws of the United States. 19 U.S.C. § 81c. Nothing in those provisions provides an exemption from state and local taxes.

The only remaining question is whether imposition of the tax is prohibited by the constitutions of the United States or Tennessee. Other than Article II, § 28, discussed above, there is no issue of Tennessee constitutional law under the facts provided.

Regarding the United States Constitution, as discussed previously in this ruling, the [YEAR] Treaty prohibits the United States from imposing federal income tax on [THE TAXPAYER'S] business profits. The Treaty provisions, however, do not apply to state and local taxes. Notwithstanding that fact, the Treaty is relevant in determining whether imposition of business tax would violate the Commerce Clause.

As noted above, to withstand a challenge under the Commerce Clause the tax must meet the four tests of *Complete Auto*. In addition, the tax will not burden foreign commerce if (1) there is not a substantial risk of double taxation and (2) the tax does not prevent the United States from speaking with "one voice" when regulating commerce with foreign nations. *Japan Line, Ltd.*, 441 U.S. at 444-451, 99 S.Ct. at 1819-1823.

Under the facts provided, imposition of business tax meets the four prong test of *Complete Auto*.

In *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 184, 115 S.Ct. 1331, 1338 (1995), the Supreme Court stated that "[i]t has long been settled that a sale of tangible goods has a sufficient nexus to the state in which the sale is consummated to be treated as a local transaction taxable by that state." In this case, the tax is upon the privilege of engaging in the business of selling tangible goods in Tennessee. Clearly, this activity has a substantial nexus with Tennessee.

The tax also meets the fair apportionment requirement. The Supreme Court further stated in *Jefferson Lines* that "[a] sale of goods is most readily viewed as a discrete event facilitated by the laws and amenities of the place of sale. . . ." *Jefferson Lines, Inc.*, 514 U.S. at 186, 115 S.Ct. at 1339. The Court has therefore "consistently approved taxation of sales without any division among different States, and [has] 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." *Id*. Again, the tax at issue is upon the privilege of engaging in the business of making sales of goods in Tennessee. Under the rationale in *Jefferson Lines* the tax is properly measured by the entire amount of the sales occurring in Tennessee.

The third portion of the *Complete Auto* test provides that the tax must not discriminate against interstate commerce. This prong of the test means a state cannot provide a direct commercial advantage to local business or discriminate against commercial activity occurring outside the taxing state. *Jefferson Lines, Inc.*, 514 U.S. at 197, 115 S.Ct. at 1344-1345. In this case, the same tax is imposed in the same manner regardless of whether the goods are shipped in-state or out-of-state following the sale. Also, [THE TAXPAYER] will be subject to tax in the same manner as a Tennessee company making sales from the same locality. Accordingly, this requirement is met as well.

Finally, it is clear that the tax is fairly related to the services provided by the state. [THE TAXPAYER] will have assets in Tennessee. [THE TAXPAYER] will, among other things, be entitled to fire and police protection, access to Tennessee courts, and will enjoy the privilege of having its products transported over Tennessee's streets and highways.

The remaining consideration, then, is whether application of business tax would violate the two additional *Japan Line* tests. Based on the facts provided, application of business tax will not violate those tests.

There is not a substantial risk of double taxation. As discussed above, excise tax is measured by [THE TAXPAYER'S] income and presents a substantial risk of international double taxation because, under the Treaty, [FOREIGN COUNTRY A] is able to tax all of [THE TAXPAYER'S] income. Business tax, however, is measured not by income but by [THE TAXPAYER'S] gross receipts from its sales in Tennessee. Nothing in the Treaty or in the facts indicates that the business tax presents a risk of double taxation; nor has [THE TAXPAYER] asserted any such risk.

Similarly, the tax does not prevent the United States from speaking with "one voice" when regulating commerce with foreign nations. As just stated, the tax at issue is not affected by the Treaty, which covers federal income tax in the United States as well as income tax, company tax, tax on salaries, and wealth tax in [FOREIGN COUNTRY A]. Under the facts provided, it does not appear that any of these taxes relate to the privilege of carrying on business in Tennessee. Also, there is no evidence that retaliation, international disputes over apportionment formula, or varying degrees of multiple taxation will result from the imposition of Tennessee's business tax. *See Japan Line*, 441 U.S. at 450, 99 S.Ct. at 1822-1823. Accordingly, the federal government has not spoken on this issue, and imposition of the tax does not prevent the United States from doing so.

Conclusion

Tennessee's imposition of its excise tax on the business profits of [THE TAXPAYER] would violate the commerce clause and thus be constitutionally impermissible. Imposition of the tax would create a substantial risk of multiple taxation and would impair the United States government's ability to speak with "one voice" when regulating commerce with [FOREIGN COUNTRY A]. Tennessee's imposition of its business tax, however, would not violate the commerce clause and would thus be constitutionally permissible.

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