TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 01-07

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 from 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 tax to a [FOREIGN COUNTRY A] domiciled corporate subsidiary of a [FOREIGN COUNTRY P] parent corporation where the [FOREIGN COUNTRY A] domiciled 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

[TAXPAYER] is the 100% subsidiary of [PARENT CORPORATION] of [FOREIGN COUNTRY P]. [PARENT CORPORATION] in [FOREIGN COUNTRY P] is owned by [X CORPORATION] of [FOREIGN COUNTRY P] and [Y COMPANY] of [FOREIGN

COUNTRY P]. [TAXPAYER] is domiciled in [FOREIGN COUNTRY A]. [TAXPAYER] does not have a subsidiary, employees or facilities in the United States. It does, however, have manufacturing customers in Tennessee, [STATE A – NOT TENNESSEE] and [STATE B – NOT TENNESSEE] to which it sells [PRODUCTS]. One or more of the manufacturers desire to have a "just in time" inventory delivery system. [TAXPAYER] is therefore contemplating the following:

[TAXPAYER] will retain the services of an independent warehouseman to handle its products. The warehouseman will store the [TAXPAYER] products at a facility which 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 [TAXPAYER] will be shipped from [FOREIGN COUNTRY B], [FOREIGN COUNTRY A], [FOREIGN COUNTRY C], [FOREIGN COUNTRY D] and [FOREIGN COUNTRY P] to the warehouse in Tennessee. Those [PRODUCTS] will then be shipped directly from the warehouse to customers in Tennessee, [STATE A – NOT TENNESSEE] and [STATE B – NOT TENNESSEE]. The customers will communicate with [TAXPAYER] in [FOREIGN COUNTRY B], which is the Sales Branch Office, regarding its product needs. The warehouseman will remove the product from the warehouse, ship the product to the customer and inform [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 Tennessee, [STATE A – NOT TENNESSEE] and [STATE B – NOT TENNESSEE], the products are no longer owned by [TAXPAYER] .

[TAXPAYER] will not have employees in Tennessee, a business location in Tennessee or any other Tennessee connections that would give rise to a "permanent establishment" as defined under the United States-[FOREIGN COUNTRY A] tax treaty.[1] The warehouseman is not an employee of [TAXPAYER], but an independent agent.

As a foreign[2] corporation, [TAXPAYER] will be required to file form 1120-F with the Internal Revenue Service. Due to the fact that [TAXPAYER] will not have a permanent establishment[3]

---

[1] *Convention for the avoidance of Double Taxation,* [DATE], U.S.-[FOREIGN COUNTRY A]., art., ¶ 1, CCH Tax Treaties, Vol.II.

[2] 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.

[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

under the United States-[FOREIGN COUNTRY A] tax treaty, the United States will not have jurisdiction to impose its federal income tax on [TAXPAYER]. [TAXPAYER] will, therefore, have zero federal taxable income reported on its 1120-F.

ISSUE

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

RULING

No.

ANALYSIS

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 expanded application of Tennessee's franchise, excise taxes to other types of business entities. The expansion was further refined in Public Chapter 982 of the Public Acts of 2000. See, T.C.A. § 67-4-2004(16). 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 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[4] doing for profit business in Tennessee. T.C.A. §§ 67-4-2105 and 67-4-2007. Therefore, absent a federal law or a constitutional prohibition, [TAXPAYER], like every other person who does business in Tennessee, will be required to pay Tennessee franchise and excise taxes.[5]

In [YEAR], [FOREIGN COUNTRY A] and the United States entered into an income tax treaty ("Treaty").[6] By its terms, the Treaty applies only to persons[7] who are residents of [FOREIGN

---

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] The term "person" is defined broadly to include "every corporation, subchapter S corporation, limited liability company, limited liability partnership, professional registered limited liability partnership, limited partnership, cooperative, joint-stock association, business trust, regulated investment company, real estate investment trust, state-chartered or national bank, state-chartered or federally chartered savings and loan association." Tenn. Code Ann. § 67-4-2004(16).

[5] [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 [TAXPAYER].

[6] *Convention for the avoidance of Double Taxation,* [DATE], U.S.-[FOREIGN COUNTRY A]. CCH Tax Treaties, Vol.II.

COUNTRY A], the United States, or both.[8] 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 business profits of an enterprise of a Contracting State[9] 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.

Convention for the Avoidance of Double Taxation, [DATE], U.S.-[FOREIGN COUNTRY A], 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, ¶ 4.

Furthermore, the Treaty provides that:

[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 [TAXPAYER]'s assertion that the Treaty prohibits the United States from imposing federal income taxes upon [TAXPAYER]'s business profits. Whether Tennessee can tax [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 some other prohibition against taxation, either in the form of a federal

---

7 For purposes of the Treaty the term "person" includes but is not limited to an individual and a company.

8 *Convention for the avoidance of Double Taxation,* [DATE], U.S.-[FOREIGN COUNTRY A], art., 1, CCH Tax Treaties, Vol.II.

9 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.

law or a constitutional prohibition, in order to relieve [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. U.S. Constitution Art. 1, § 8, cl.3. 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").[10] The Commerce 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 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, 448, 99 S.Ct 1813, 1821, 60 L.Ed2d 336 (1979). 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.*

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, 51 L.Ed2d 326 (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;

(2) the tax was fairly apportioned;

(3) the tax did not discriminate against interstate commerce; and

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

(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. Therefore, to determine whether Tennessee could impose its excise tax on [TAXPAYER]'s proposed business activities in Tennessee, one must apply the tests set forth in *Complete Auto*, supra, and *Japan Line*, supra.

I. <u>Application of Tennessee's Excise Tax to the Complete Auto Factors</u>

In applying the four factors of *Complete Auto* to [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). [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 [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.*. 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.* (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.

Tennessee's excise tax would be fairly apportioned as the tax would be based on [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 [TAXPAYER] transacted in Tennessee and if this method of apportionment were applied in every jurisdiction in which [TAXPAYER] does business it would result in no more than all of the unitary business income being taxed.[11] Therefore, the second prong of the *Complete Auto* test is satisfied.

3) Discrimination Against Interstate Commerce - If [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. Tennessee's excise tax would not discriminate against interstate commerce because it would not place any greater burden on interstate commerce than the taxes place upon intrastate commerce of like character. In other words, Tennessee's excise tax would not be discriminatory against [TAXPAYER] because [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. The general government services that facilitate a taxpayer's business are sufficient to establish the state's taxing authority. See, *Cole Brothers Circus*, supra.. As [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 [TAXPAYER] that will facilitate its business operations in Tennessee. The excise tax that would be imposed upon [TAXPAYER] as a result of its activities and presence in Tennessee would be fairly related to the services that Tennessee provides to [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*, [TAXPAYER] is subject to a tax treaty that gives [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[12], [TAXPAYER] will not have a domestic subsidiary. Furthermore, [TAXPAYER] will not have a permanent establishment in the United States and will not be subject to paying federal income tax.

---

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

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 [TAXPAYER] so long as [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.

Secondly, imposition of Tennessee's excise tax on [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, [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]'s company, any attempt by Tennessee to impose a tax on [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 were allowed to impose taxes on the business profits of [FOREIGN COUNTRY A] Companies in derogation of the Treaty.

Conclusion

Tennessee's imposition of its excise tax on the business profits of [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].

Steven B. McCloud
Tax Counsel

APPROVED: Ruth E. Johnson
Commissioner

DATE: 5/2/01