STATE OF TENNESSEE

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November 8, 2004

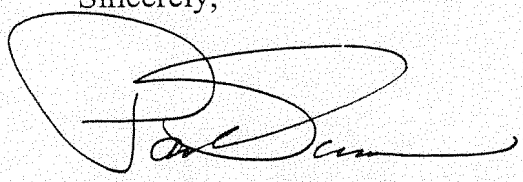
The Honorable Loren L. Chumley
Commissioner of Revenue
1200 Andrew Jackson Building
Nashville, Tennessee 37242

Dear Commissioner Chumley:

Pursuant to your request, enclosed is Opinion No. 04-159.

If you have further questions or comments, please contact this Office.

Sincerely,



PAUL G. SUMMERS
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Enclosure

STATE OF TENNESSEE
OFFICE OF THE
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PO BOX 20207
NASHVILLE, TENNESSEE 37202

November 8, 2004

Opinion No. 04-159

Inapplicability of Public Law 86-272 to the Tennessee Franchise Tax

## QUESTION

Whether 15 U.S.C. § 381(a)(better known as Public Law 86-272) exempts an entity conducting business in Tennessee from franchise tax liability imposed by Tenn. Code Ann. §§ 67-4-2101 *et seq.* if the entity's only business activities in Tennessee include the solicitation of orders for tangible personal property which are approved and delivered from locations outside Tennessee.

## OPINION

No. Since Public Law 86-272 applies only to state taxes measured by net income, that provision is not applicable to the Tennessee franchise tax, which is measured by the net worth of the taxpayer.

## ANALYSIS

The Tennessee franchise tax is imposed by Tenn. Code Ann. §§ 67-4-2101 *et seq.* upon the privilege of doing business in Tennessee. The term "doing business" is defined in Tenn. Code Ann. § 67-4-2004(7)(A) as follows:

> "Doing business in Tennessee" or "doing business within this state" means any activity purposefully engaged in, within Tennessee, by a person with the object of gain, benefit, or advantage, consistent with the intent of the general assembly to subject such persons to the Tennessee franchise/excise tax to the extent permitted by the United States Constitution and the Constitution of Tennessee.

The franchise tax is imposed on a taxpayer's net worth, defined in Tenn. Code Ann. § 67-4-2106(b) as "the difference between a taxpayer's total assets less its total liabilities computed in accordance with generally accepted accounting principles."

The Tennessee franchise tax levied by Tenn. Code Ann. §§ 67-4-2101 *et seq.* is not a tax measured by net income. The Legislature enacted the present franchise tax statutes in 1999, replacing the earlier provisions enacted in 1937 and reenacted in 1976. The Legislature intended the

franchise tax to apply to a taxpayer's exercise of the privilege of doing business regardless of earnings or losses. *Commercial Equities v. Tollett*, 596 S.W.2d 801, 804 (Tenn.1980). While the franchise tax levied by Tenn. Code Ann. §§ 67-4-2101 *et seq.* and the excise tax levied by Tenn. Code Ann. §§ 67-4-2001 *et seq.* are both imposed on the privilege of doing business in Tennessee, liability under the franchise tax is very different from liability under the excise tax, which is measured by net earnings apportioned to Tennessee. Thus, while the Tennessee excise tax clearly is a tax measured by net income, the Tennessee franchise tax just as clearly is not such a tax.

The primary question presented here is whether a taxpayer doing business in Tennessee by soliciting orders for tangible personal property and delivering those orders from locations outside Tennessee is exempt from Tennessee franchise tax liability under the provisions of Public Law 86-272. Public Law 86-272, codified as 15 U.S.C. §§ 381-84, sets forth the following limitations with respect to the "Imposition of [a] Net Income Tax":

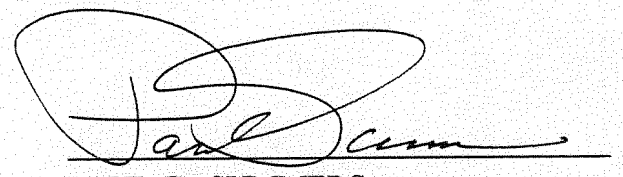
> (a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, ***a net income tax*** on the income derived within such State by any person from interstate commerce ***if the only business activities within such State*** by or on behalf of such person during such taxable year are either, or both, of the following:
> (1) the ***solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State***; and
> (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1). (emphasis added)

The United States Constitution imposes certain restrictions on a state's power to subject foreign corporations and other nonresidents to taxes on their business activities in interstate commerce. Under the Due Process Clause, a minimum connection must exist between a state and the person, property, or transaction the state seeks to tax. *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). The Commerce Clause also limits a state's taxing jurisdiction to activities with a substantial nexus to the taxing state. *Id.* While it is sometimes unclear whether a business has sufficient connection to be taxable within a state, a business that systematically solicits orders through a sales force located in Tennessee will be subject to the state's taxing jurisdiction under established precedents. *See Scripto v. Carson*, 362 U.S. 207, 80 S. Ct. 619, 4 L. Ed. 2d 660 (1960); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999). For an entity conducting business in Tennessee with sufficient contacts to satisfy the requirements of the Due Process Clause

and the Commerce Clause, Tennessee may assert its taxing jurisdiction unless the entity comes within the protection of Public Law 86-272.

Public Law 86-272 prohibits a state from subjecting a nondomiciliary business to a net income tax where that business's only activities within the state consist of solicitation activities for sales of tangible personal property. The most basic principle of statutory construction is to ascertain and give effect to the legislative intent as expressed in the statute. *Hughes Air Corp. v. Public Utilities Com'n*, 644 F.2d 1334, 1337 (9th Cir.1981); *Watt v. Alaska*, 451 U.S. 259, 265, 101 S.Ct. 1673, 1677, 68 L.Ed.2d 80 (1981). The plain meaning of the language of Public Law 86-272 limits the application of this statute to state taxes "measured by net income." No reported cases have held that this provision applies to taxes other than taxes measured by income. Courts in other states have held that Public Law 86-272 does not prevent a state from imposing taxes such as a single business tax, a business privilege tax, a franchise tax measured by net worth, or a capital stock tax. *Guardian Industries Corp. v. Dept. of Treasury,* 499 N.W.2d 349, 373 (Mich. Ct. App. 1993); *Clairol, Inc. v. Kingsley*, 262 A.2d 213 (N.J. Super. 1970). While the U.S. Supreme Court has struggled in defining exactly which activities amount to solicitation of orders within the meaning of Public Law 86-272, it has not indicated in any way that the law could apply to any tax other than a state tax on or measured by net income, as the law plainly states. *See Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 112 S. Ct. 2447, 120 L. Ed. 2d 174 (1992).

In conclusion, the plain meaning of Public Law 86-272 is that its limitations apply only to taxes measured by net income. Since the Tennessee franchise tax is measured by a taxable entity's net worth and not by net income, Public Law 86-272 does not impose any restrictions with respect to the application of the franchise tax, even in instances in which it does prohibit application of the excise tax.



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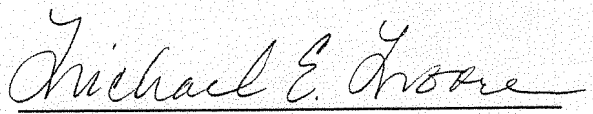

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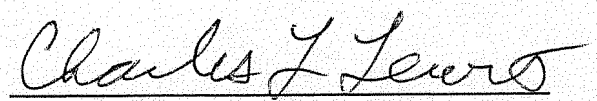

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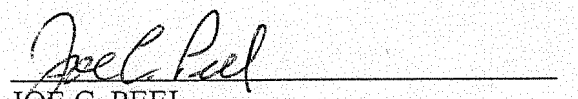

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Requested by:

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