

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 12-27**

WARNING

Revenue rulings are not binding on the Department. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax practitioner before relying on any aspect of this ruling.

SUBJECT

Whether the licensing of patents, the use of which gives rise to Tennessee sales by an affiliated licensee, causes the licensor to be subject to the Tennessee franchise and excise taxes.

SCOPE

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

FACTS

Company A is a [STATE – NOT TENNESSEE] corporation that is principally engaged in the business of holding, managing, and licensing certain patents. Company A is a member of an affiliated group of companies that manufacture and sell [TYPE OF] products.¹

Patents held by Company A cover the use, manufacture, and sale of [TYPE OF] products (the “Products”). Company A maintains an office in [STATE – NOT TENNESSEE], where it incurs payroll and other operating expenses. Company A has no office or employees in Tennessee, and does not own or lease tangible property in Tennessee. Company A does not solicit licensing opportunities in Tennessee. [REDACTED].

Patents owned by Company A are licensed to Company B, an affiliated business entity. Company B arranges for the manufacture of the Products by Company C, another affiliate. Company C manufactures the Products in [VARIOUS LOCATIONS – NOT TENNESSEE] and then sells them to Company B at an arm’s length price. Company C then ships the Products to Company B’s warehouse in [STATE – NOT TENNESSEE]. All of Company B’s employees and its [REDACTED] warehouse and distribution facility are located in [STATE – NOT TENNESSEE]. Company B does not have any employees in Tennessee and does not have any property in Tennessee.

Company B has entered into a product supply agreement with Partnership D under which Company B agrees to supply Partnership D’s requirements for the Products. Company E, another

¹ The taxpayer has requested a revenue ruling only with respect to Company A.

affiliated entity, owns a 1% interest in Partnership D; an unrelated third party owns the other 99% interest in Partnership D. Company B sells the Products to Partnership D and then ships the Products via common carrier to Partnership D's warehouse facilities in [LOCATIONS – NOT TENNESSEE], and/or Tennessee. Partnership D then sells and distributes the Products throughout the United States, including the State of Tennessee.

Company B pays a royalty to Company A for use of the patents, based on a percentage of Company B's sales to Partnership D. The royalty is due and payable once Partnership D has sold the Products to its customers.

RULING

Is Company A subject to the Tennessee franchise and excise taxes based solely on its licensing of patents, the use of which gives rise to Tennessee sales by a related licensee?

Ruling: No. Company A is not subject to the Tennessee franchise and excise taxes under the facts presented, where Company A's contact with Tennessee arises solely from the eventual sale and delivery by Company B into Tennessee of Products manufactured outside the state using Company A's patents.

ANALYSIS

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, as defined under TENN. CODE ANN. § 67-4-2004(37) (2011), doing business within Tennessee. TENN. CODE ANN. § 67-4-2007(a) (2011). Tennessee also imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of a person doing business in Tennessee, pursuant to TENN. CODE ANN. §§ 67-4-2105(a), -2106(a) (2011).² Persons subject to the Tennessee franchise and excise taxes include, but are not limited to, corporations and limited liability companies. TENN. CODE ANN. § 67-4-2004(37).

“Doing business in Tennessee” is defined for franchise and excise tax purposes as “any activity purposefully engaged in, within Tennessee, by a person with the object of gain, benefit, or advantage,” to the extent permitted by the United States Constitution and the Constitution of Tennessee. TENN. CODE ANN. § 67-4-2004(14)(A). Tennessee's power to tax out-of-state sellers is limited by both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of Article I, Section 8, of the United States Constitution. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

Therefore, for Company A to have a Tennessee franchise and excise tax filing obligation, the following requirements must be met: (1) Company A must be “doing business” in Tennessee; and (2) Tennessee's power to tax Company A must not be prohibited by the Due Process Clause or the Commerce Clause of the United States Constitution.

² Note that, under TENN. CODE ANN. § 67-4-2108(a)(1) (2011), the franchise tax base “shall in no case be less than the actual value of the real or tangible property owned or used in Tennessee, excluding exempt inventory and exempt required capital investments.” For purposes of this section, “property” is to be “valued at cost less accumulated depreciation in accordance with generally accepted accounting principles.” TENN. CODE ANN. § 67-4-2108(a)(3).

Company A is not “doing business in Tennessee” as the term is defined under TENN. CODE ANN. § 67-4-2004(14)(A). As noted above, “doing business in Tennessee” is defined for franchise and excise tax purposes as (1) any activity purposefully engaged in (2) within Tennessee (3) by a person with the object of gain, benefit, or advantage. TENN. CODE ANN. § 67-4-2004(14)(A).

While Company A does purposefully engage in patent licensing activities with the object of gain, benefit, or advantage, it does not do so within Tennessee.

Under the facts as presented, Company A has no office or employees in Tennessee and does not own or lease tangible property in Tennessee. Company A does not solicit licensing opportunities in Tennessee. Company A licenses its patents to Company B, an affiliated business entity. All of Company B’s employees and its sole warehouse and distribution facility are located in [STATE – NOT TENNESSEE]. Company B arranges for the manufacture of the Products by Company C, another affiliate. Company C manufactures the Products outside Tennessee and then sells them to Company B at an arm’s length price. Company C ships the Products to Company B’s warehouse in [STATE – NOT TENNESSEE]. Company B sells the Products to Partnership D, which is 1% owned by another affiliate of Company A. Company B then ships the Products via common carrier to Partnership D’s warehouse facilities in [VARIOUS LOCATIONS – NOT TENNESSEE] and/or Tennessee. Partnership D then sells and distributes the Products throughout the United States, including the State of Tennessee. Company B pays a royalty to Company A for use of the patents, based on a percentage of Company B’s sales to Partnership D.

The facts indicate that Company A’s contact with Tennessee arises solely from the eventual sale and delivery by Company B into Tennessee of Products manufactured outside the state using Company A’s patents. Under these facts, Company A’s contact with Tennessee is too remote and indirect so as to be characterized as an activity “purposefully engaged in” within the state with the object of gain, benefit, or advantage.³

Company A is therefore not “doing business in Tennessee” as the term is defined under TENN. CODE ANN. § 67-4-2004(14)(A).

Because Company A is not “doing business in Tennessee” for purposes of the Tennessee franchise and excise taxes, this revenue ruling will not address whether Tennessee’s power to tax Company A is limited by the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of Article I, Section 8, of the United States Constitution.

In summary, Company A is not subject to the Tennessee franchise and excise taxes under the facts presented, where Company A’s contact with Tennessee arises solely from the eventual sale and delivery by Company B into Tennessee of Products manufactured outside the state using Company A’s patents.

³ Note that if Company A licensed its patents to an affiliate that used the patents in a manufacturing facility in Tennessee, Company A could be characterized as doing business in Tennessee. *See Praxair Tech., Inc. v. Dir., Div. of Taxation*, 988 A.2d 92, 99 (N.J. 2009) (holding that a corporation with no physical presence in New Jersey was doing business in the state where the corporation licensed patents to an affiliate for use in the manufacture of products in New Jersey).

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APPROVED: Richard H. Roberts
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