

PUBLICATION

Spotlight on Tennessee: Did the Department of Revenue Just Announce Plans to Assert Economic Presence Nexus?

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If polled, most practitioners and commentators would likely contend that the State of Tennessee requires an out-of-state company (that is not a financial institution) to have a physical presence in Tennessee before the company is subject to this State's excise and franchise taxes. This position is supported by the Tennessee Court of Appeals' decision in *J.C. Penney National Bank v. Johnson*. Nonetheless, the Court of Appeals' decision in *America Online, Inc. v. Johnson* could be read by some, including possibly the Tennessee Department of Revenue (Department), to limit *J.C. Penney* to the facts and circumstances at issue in the U.S. Supreme Court's *Quill Corp. v. North Dakota* decision. However, *America Online* is an unpublished decision and arguably not precedential. Despite this background, did the Department just show its hand in the recently published Revenue Ruling #12-27, dated November 14, 2012?

Ruling Facts

In Revenue Ruling #12-27, a corporation with no physical presence in Tennessee (Company A) owned, managed and licensed patents. Company A licensed its patents to an affiliate, Company B, which arranged for the manufacture of products by another affiliate, Company C. Company C was granted the right to use the patents to manufacture the products, but did not license the patents. Companies A, B, and C had no physical presence in Tennessee. Company C sold the finished products to Company B and shipped them to Company B's warehouse and distribution facility that was outside Tennessee. Company B entered into a product supply agreement with Partnership D, and shipped the products via common carrier to Partnership D's warehouses in Tennessee and other states. Partnership D sold the products throughout the United States, including Tennessee.

The Department's conclusion that Company A was not "doing business" in Tennessee and was not subject to the excise and franchise taxes is not all that surprising. Company A had no physical presence in Tennessee under *J.C. Penney*, and the products were ultimately shipped into Tennessee via common carrier under *Quill* and *America Online*. While one could be concerned that Partnership D's Tennessee physical presence may be attributed to Company A (or Company B), nothing in the ruling suggests that Partnership D (whose 1 percent partner was Company E, another affiliate of Company A, but whose 99 percent partner was unrelated) engaged in activities in Tennessee that were substantially associated with Company A's ability to establish and maintain a market in Tennessee. The buy/sell product supply arrangement was between Company B and Partnership D, and Partnership D sold the products apparently for its own account, rather for the account of Company B or Company A.

Footnote 3

However, footnote 3 is noteworthy. In that footnote, the Department suggests that "if Company A licensed its patents to an affiliate that used the patents in a manufacturing facility in Tennessee," then Company A could be "doing business" in Tennessee and presumably subject to excise and franchise taxes. While the Department's note is in the context of Tennessee's statutory doing business standard and was not a contention by the Department that such a fact pattern would satisfy Due Process Clause minimum contacts or Commerce Clause substantial nexus requirements, the Department did cite to *Praxair Technology, Inc. v. Dir., Division of*

Taxation. In *Praxair* the New Jersey Supreme Court held that licensing patents for use in New Jersey and receipt of royalty income from such use satisfied the substantial nexus requirement of the dormant Commerce Clause.

Summary

As a result, although Revenue Ruling #12-27 provides helpful guidance to out-of-state companies licensing and using patents to manufacture products outside Tennessee that will be supplied for the Tennessee market, footnote 3 in such Ruling suggests that the Department's administrative policy and audit positions may possibly be shifting to the economic presence nexus theory.

If you would like to discuss this Revenue Ruling or other Tennessee state or local tax issues, please contact any member of the Firm's Tax Department.