

State and Local Tax Bulletin

December 2, 2009
Tennessee Edition



Tennessee Franchise and Excise Taxes: Judicial Update

By Joseph W. Gibbs, Patricia Head Moskal and Brian S. Shelton

Upcoming Seminars Involving Members Of Our SALT Practice Group

December 14-15, 2009

The 28th NYU Institute on State and Local Taxation will be held at The Grand Hyatt, New York. Bruce Ely will serve on a panel providing an in-depth review of significant tax developments from regions across the country, entitled: "What's Happening Everywhere Today?" For more information, please visit www.scps.nyu.edu/salt.

January 21-23, 2010

American Bar Association Tax Section Winter Meeting, Grand Hyatt Hotel, San Antonio, Texas. Bruce Ely and Will Thistle will be speakers in a panel presentation on "State Administrative Procedure Acts: Procedural Avenues to Attack Faulty Regulations and Assessments." For more information, please visit the ABA website: www.abanet.org/tax/meetings.

January 28-29, 2010

Council On State Taxation 2010 SALT Basics School, Georgia Tech Hotel & Conference Center, Atlanta, Georgia. Chris Grissom will be a co-panelist in a presentation on preparing internal research memoranda and the interplay with the attorney-client privilege and work product doctrine. For more information, please visit the COST website: www.statetax.org.

Unitary/Non-Unitary Business: Excise Tax on Interest Income Earned on Treasury Securities Held Unconstitutional.*

The Tennessee Court of Appeals recently held in favor of the taxpayer, declaring that Tennessee's assessment of excise tax on interest earned on funds invested in treasury securities was unconstitutional in *Siegel-Robert, Inc. v. Johnson*. The Court found that under the "unitary business principle" the investments were used for investment purposes, not operational purposes, and the taxpayer's investment activities conducted outside the state were not unitary with its manufacturing activities in Tennessee.

This case squarely addresses the limits of a state's constitutional power to reach outside its borders and require apportionment of income earned outside the taxing state. The taxpayer was a multistate corporation with its headquarters and commercial domicile in St. Louis, Missouri. The taxpayer conduct its business through several manufacturing divisions and subsidiaries. Its largest division was engaged in automotive parts manufacturing with facilities in Tennessee and several other states. The taxpayer routinely invested excess cash not needed for operational purposes in overnight repurchase agreements. The taxpayer included the interest earned on the repurchase agreements in its business earnings. However, when the taxpayer accumulated cash significantly in excess of its operational needs, it moved the excess funds to its investment portfolio where the funds were invested in treasury securities for periods ranging from one to four years. Only the interest earned on the treasury securities was at issue in the case. When the treasury securities matured, the taxpayer either reinvested the funds into other treasury securities or used the proceeds to make business acquisitions to implement its long-term diversification strategy. All of the taxpayer's investment activities were conducted from its headquarters in Missouri and were held by financial institutions in St. Louis.

On its Tennessee return, the taxpayer reported the interest earned on the treasury securities as nonbusiness earnings not subject to apportionment for excise tax purposes. The Department of Revenue disagreed and treated the interest earned on the treasury securities as apportionable business earnings subject to excise tax.

The taxpayer challenged the tax assessment on two grounds: (1) the interest income was "non-business earnings" for Tennessee excise tax purposes; and (2) the tax assessment was unconstitutional under the unitary business principle because there was no unitary relationship between the taxpayer and the payor of the interest income, the United States government, and the investments served an investment purpose, not an operational purpose. On cross-motions for summary judgment, the trial court held in favor of the taxpayer on both grounds and the Commissioner appealed.

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The Court of Appeals held the excise tax assessment unconstitutional. Applying the unitary business principle analysis set forth in the U.S. Supreme Court decisions in *Allied-Signal, Inc. v. Director, Div. of Taxation*, and *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, the Court stated that the relevant inquiry focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. Under the facts, it was obvious that there was no unitary relationship between the taxpayer and the payor of the income.

Turning to the second test under the unitary business principle, the Court found that there was no unitary relationship between the taxpayer's out-of-state investment activities and its in-state manufacturing activities where the treasury securities served an investment purpose, not an operational one. It is unknown whether the Commissioner will apply for a discretionary appeal to the Tennessee Supreme Court, and the time period to do so has not expired. *Siegel-Robert, Inc. v. Johnson*, 2009 WL 3486625 (Tenn. Ct. App. Oct. 28, 2009)

* The authors' firm represents the taxpayer in this appeal.

Unitary/Non-Unitary Business: Capital Gains from Stock Redemption Held Not Taxable.

In another unitary/non-unitary business case, the Tennessee Court of Appeals again affirmed a trial court decision in favor of the taxpayer, holding that capital gains from a stock redemption transaction were not subject to apportionment in Tennessee for excise tax purposes because the taxpayer and its parent corporation were not part of a unitary business in *Blue Bell Creameries, LP v. Chumley*.

The taxpayer was an out of state limited partnership that produced, sold and distributed ice cream in Tennessee and elsewhere. As part of a corporate reorganization, the taxpayer momentarily held stock of its holding company, which directly or indirectly owned the various interests that comprised the taxpayer, and the holding company then redeemed the stock. On the taxpayer's federal income tax return, it reported capital gains from the stock redemption transaction and Tennessee assessed excise tax on that transaction claiming that the gains were taxable business earnings. The taxpayer paid the tax and sued for a refund. The trial court held that there was no unitary relationship between the taxpayer and the holding company and, therefore, Tennessee's tax on the capital gains from the stock redemption transaction violated the federal constitution. The Commissioner appealed.

The Court of Appeals agreed with the trial court and held the tax unconstitutional. Applying the unitary business principle analysis as set forth in *Allied-Signal* and *MeadWestvaco* (cited above), the Court concluded that the taxpayer and its parent were not unitary businesses under the "hallmarks of a unitary relationship" test (functional integration, centralized management, and economies

of scale). The Court of Appeals also held that the capital gains did not serve an operational function having been distributed to the taxpayer's partners. The Commissioner has filed an application for permission to appeal to the Tennessee Supreme Court. *Blue Bell Creameries, LP v. Chumley*, 2009 WL 3126249 (Tenn. Ct. App. Sept. 29, 2009).

Apportionment Formula: Commissioner's Variance Authority Upheld.

The Commissioner of Revenue's authority to impose a variance to alter the standard franchise and excise tax apportionment formula was upheld by the Court of Appeals in *BellSouth Advertising & Pub. Corp. v. Chumley*. The variance was imposed under Tennessee's version of the Uniform Division of Income for Tax Purposes Act ("UDITPA") on the basis that the statutory formula did not fairly reflect the extent of the taxpayer's business activity in Tennessee. The taxpayer challenged the variance.

The taxpayer was engaged in the business of providing advertising services in connection with telephone directories distributed in Tennessee and other states. The parties stipulated that the taxpayer's sales of the advertising services were "sales other than sales of tangible personal property." Under UDITPA, where a taxpayer's sales are other than sales of tangible personal property and the income-producing activities are performed in multiple states, the sales are attributable to Tennessee only if a greater proportion of the income-producing activities are performed in Tennessee than any other state based on costs of performance. Using this costs of performance analysis, the taxpayer sourced its sales outside Tennessee because its income-producing activities were conducted outside the state. Applying the standard apportionment formula, the taxpayer paid slightly less than \$300,000 in Tennessee franchise and excise taxes even though the taxpayer derived almost \$900,000,000 in advertising revenues from the distribution of nearly 24,000,000 telephone directories in Tennessee.

The Department of Revenue audited the taxpayer and imposed a variance to alter the costs of performance analysis, stating that the variance was necessary to fairly represent the extent of the taxpayer's business in the state. The Department issued a tax assessment of almost \$9,900,000, plus interest. Following the trial, the court invalidated the Commissioner's variance and held that the statutory cost of performance formula, which is presumed to be correct, was appropriate and the Commissioner had failed to prove otherwise. The Commissioner appealed.

The Court of Appeals reversed, finding that the variance from the cost of performance formula was appropriate, based on the substantial advertising revenues derived from the taxpayer's activities within the state. The taxpayer has filed an application for permission to appeal to the Tennessee Supreme Court. *BellSouth Advertising & Pub. Corp. v. Chumley*, 2009 WL 2632773 (Tenn. Ct. App. Aug. 26, 2009).

2009 Legislative Update

For a summary of the 2009 Tennessee legislative update for franchise and excise taxes, please see our SALT Bulletin: Tennessee Edition -- "2009 Tennessee Tax Legislative Update" at www.babc.com. For more information, please contact Joseph W. Gibbs, Patricia Head Moskal or Brian S. Shelton.

Bradley Arant Boulton Cummings LLP Office Locations:

ALABAMA

One Federal Place
1819 Fifth Avenue North
Birmingham, AL 35023
(205) 521-8000

200 Clinton Avenue West, Suite 900
Huntsville, AL 35801
(256) 517-5100

The Alabama Center for Commerce
401 Adams Avenue, Suite 780
Montgomery, AL 36104
(334) 956-7700

MISSISSIPPI

188 E. Capitol Street, Suite 450
Jackson, MS 39201
(601) 948-8000

NORTH CAROLINA

100 North Tryon Street, Suite 2690
Charlotte, NC 28202
(704) 338-6000

TENNESSEE

1600 Division Street, Suite 700
Nashville, TN 37203
(615) 244-2582

WASHINGTON, DC

1133 Connecticut Avenue NW,
12th Floor
Washington, DC 20036
(202) 393-7150

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SALT Practice Group:

Bruce P. Ely, Chair
(205) 521-8366
bely@babc.com

Joseph W. Gibbs
(615) 252-2317
jgibbs@babc.com

W. Stanley Gregory
(334) 956-7604
sgregory@babc.com

Christopher R. Grissom
(205) 521-8514
cgrissom@babc.com

K. Wood Herren
(205) 521-8505
wherren@babc.com

Matthew S. Houser
(205) 521-8680
mhouser@babc.com

James E. Long, Jr.
(205) 521-8626
jelong@babc.com

Patricia Head Moskal
(615) 252-2369
pmoskal@babc.com

Brian S. Shelton
(615) 252-2313
bshelton@babc.com

William T. Thistle, II
(205) 521-8985
wthistle@babc.com

Robert D. Thorington
(334) 956-7609
rthorington@babc.com

Robert C. Walthall
(205) 521-8308
rwalthall@babc.com

www.babc.com