PUBLICATION

Spotlight on Tennessee: Forced Franchise/Excise Tax Variance Upheld by Supreme Court

Authors: Carl E. Hartley
April 04, 2016

On March 23, 2016, the Tennessee Supreme Court issued its much-awaited decision in the case of *Vodafone Americas Holdings, Inc. et al. vs. Tennessee Commissioner of Revenue*. To the disappointment of many taxpayers and practitioners alike, but with apparent applause from the Tennessee Department of Revenue (Department), this state's highest court upheld the determination by the Department's Commissioner in this particular fact situation to force Vodaphone Americas Holdings, Inc. (Taxpayer) to compute its franchise and excise tax liabilities for the 2002 through 2006 years based upon an apportionment methodology proposed by the Department even though such methodology was directly contrary to the standard statutory apportionment methodology which the Taxpayer attempted to use. In upholding this forced variance, the court concluded that the standard statutory apportionment methodology did not fairly represent the extent of the Taxpayer's business activity in Tennessee. Of the five justices on the court, the one dissenting justice disagreed that the Department had satisfied its own regulatory requirements addressing when a forced assessment may be imposed.

Franchise/Excise Taxes. Tennessee's excise tax (this state's business income tax) and franchise tax (the business net worth tax) are significant revenue producers for this state. Without a general income tax, Tennessee must rely heavily on sources such as sales/use tax and franchise/excise tax collections to support budgetary needs.

Where a taxable entity conducts its operations in Tennessee and other states, its business income from the sale of goods is apportioned to Tennessee based upon a traditional statutory formula consisting of three factors (property and payroll factors together with an enhanced sales factor) so as to calculate the Tennessee franchise/excise tax liability. However, where such an entity operating in multiple states is engaged in providing services, such as telecommunications, another statutory apportionment methodology (applicable during the years in question as well as through tax years beginning before July 1, 2016) attributes earnings to Tennessee only if most of the entity's earnings-producing activities, or cost of performance, took place in Tennessee.

Background Facts. The background facts in this case are somewhat convoluted, but in essence the Taxpayer originally filed its Franchise, Excise Tax Returns using a methodology that did not directly comport with any Tennessee apportionment statute that is, Taxpayer (a telecommunication service provider) included sales to customers with Tennessee billing addresses in the sales factor of what would otherwise be the traditional apportionment formula used for the sale of goods. Taxpayer thereafter filed a lawsuit challenging in its complaint whether it was subject at all to the franchise/excise taxes and then subsequently amended its complaint so as to include the argument that the apportionment methodology initially used by the Taxpayer was incorrect and that the statutory cost of performance apportionment methodology should have been used since the Taxpayer was providing services (not selling goods) to its customers. As contended by the Taxpayer, the greater proportion of its costs associated with such services were incurred in New Jersey and therefore little if any of the Taxpayer's earnings should be attributable to Tennessee.

Following the Taxpayer's amendment to its complaint arguing the applicability of the cost of performance methodology the Department's Commissioner notified Taxpayer that the Department was forcing a variance upon the Taxpayer with respect to the methodology for apportioning earnings to Tennessee. In essence, the Commissioner advised Taxpayer that the cost of performance methodology did not fairly represent the extent of Taxpayer's business in Tennessee, and that Taxpayer would be forced to use the methodology originally used by Taxpayer in filing its Returns for the tax years in question. This forced variance issue thereafter became the main focus of the Taxpayer's litigation.

The trial court and the court of appeals held adversely to the Taxpayer and in favor of the Commissioner to enforce the variance. The Taxpayer sought review by the Tennessee Supreme Court, which granted Taxpayer's permission to appeal in November 2014.

Hopeful Anticipation. Review by the Tennessee Supreme court is discretionary, so when the court announced that it would take the Taxpayer's case for review there was a hopeful anticipation by many taxpayers and practitioners that the court would stop the Department from forcing variances upon an entity where that entity was otherwise complying with statutory tax laws in calculating income to attribute to Tennessee. In other words, if an entity conducting business in this state is currently complying with the express provisions of the applicable statutory apportionment formula, should the Department nevertheless be allowed to impose a variance upon that entity so as to require the entity to use yet another apportionment methodology which is not expressly stated in the statutes but which the Department nevertheless contends is a more appropriate measure of the entity's business activities in Tennessee?

Supreme Court's Decision. The court affirmed the Commissioner's right to impose the apportionment variance in this particular fact situation upon the Taxpayer.

In its extensive opinion, the court reviewed the history of the franchise and excise taxes pertaining, in particular, to the apportionment of income and the powers legislatively given to the Commissioner for purposes of imposing variances; and also addressed several pertinent issues such as whether the Commissioner abused his discretion by imposing the variance in question, whether the variance in question was warranted by applicable law and the Department's own regulation, whether the variance in question is in keeping with the Legislature's intent when adopting the variance statutes, among other issues.

Initially addressing the role of judicial review, the court noted that the Commissioner's discretionary decision to impose the variance must be analyzed to determine whether the factual basis for the decision is properly supported by evidence, whether the Commissioner properly identified and applied the appropriate legal principles, and whether the Commissioner's decision was within the range of acceptable alternatives.

While agreeing with the Taxpayer that the Commissioner should not have "unbridled power" and "unfettered discretion" to impose a new apportionment formula simply because the Commissioner does not like the results of the standard apportionment formula, and also separately recognizing that no apportionment method is perfect, the court nevertheless consistently determined each of the pertinent issues adverse to the Taxpayer. For example, the court noted that it is difficult to imagine a more extreme example of a situation in which application of the statutory apportionment formula does not fairly represent the extent of the Taxpayer's business in Tennessee, and that the Commissioner had ample basis to conclude in this situation that the statutory apportionment formula would not result in a fair representation of the Taxpayer's business activity in this state.

As to the concept of whether there was a fair representation of Taxpayer's business activity attributable to Tennessee, the court noted several times throughout its decision (and was similarly noted by the trial court and the Tennessee Court of Appeals) that if the Taxpayer were permitted to use the cost of performance methodology, the receipts numerator of the apportionment formula used in the Taxpayer's Returns (that is, the receipts attributable to Tennessee customers) would fall by over $1.2 billion which was characterized as an

89% difference between the numerator so used by the Taxpayer in its original Returns as compared to the cost of performance methodology which Taxpayer sought instead to use. New Jersey apparently also would not have taxed such receipts based on the nuances of its laws prompting the court on more than one occasion in its decision to characterize these earnings as "nowhere income" if the Taxpayer's cost of performance methodology is employed.

The court further determined that the alternative apportionment formula forced by the Commissioner on the Taxpayer through the variance appears to present no danger of double taxation and that under all the circumstances such alternative formula so imposed is reasonable; that the requirements of the Department's own regulation addressing variances have been satisfied since, for example, the variances applied in a limited and specific case involving an unusual fact situation that otherwise would produce incongruous results that the Department would be unable as a practical matter to verify (that is, where the greater proportion of the costs of performance occurred).

Based upon the court's analysis of apparent undisputed facts that the Taxpayer received very substantial receipts from telecommunication services to its customers located in Tennessee, yet the application of the cost of performance apportionment methodology would leave the Taxpayer paying no tax for the privilege of doing business in Tennessee, the court agreed with the trial court and the appeals court in finding no abuse of the Commissioner's discretion by imposing the variance in question.

Closing Comments. The court did agree that the Commissioner should not be permitted to have "unbridled power" and "unfettered discretion" when considering a new apportionment formula to impose upon a business entity. However, there is still the underlying concern that a business entity may believe that it is fully complying with the appropriate Tennessee statutory tax law only to be told at some later point by the Commissioner that the Department has created a different methodology that the business entity must utilize in calculating its franchise and excise tax liabilities.

Efforts to promote economic development in this state, through new as well as existing business entities, are extremely important to the growth and prosperity of this state. Those efforts can be unintentionally compromised in numerous ways, such as perceived overreaching by state agencies in dealing with business entities. Hopefully, this decision by the Tennessee Supreme Court will not become a talking point by Tennessee's competitors for economic development opportunities.

If you have questions on how this decision could impact your business or wish to discuss any other SALT related matters, please contact the author of this alert, Carl E. Hartley, or any one of our attorneys in the Firm's Tax Group.