STATE OF TENNESSEE
OFFICE OF THE ATTORNEY GENERAL

April 22, 2015

Opinion No. 15-37

Application of the Revenue Modernization Act, S.B. 603, 109th Gen. Assem. (Tenn. 2015)

Question 1

Section 7 of Senate Bill 603, referred to as the Revenue Modernization Act, would impose the excise tax on any entities having "substantial nexus" in Tennessee, as that term would be defined by Section 5 of the bill. In light of *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), is this provision constitutionally defensible?

Opinion 1

Yes. The bill's definition of "substantial nexus" is rooted in a widely-accepted theory of "economic nexus" that has attained significant currency through court decisions in many states.

Question 2

Section 8(i)(1)(C) of S.B. 603 provides that, for purposes of calculating the taxpayer's Tennessee receipts factor, sales of services are "in this state . . . if and to the extent the service is delivered to a location in this state." How will this rule be applied (i.e., where is the service "delivered") with regard to:

- services provided over the Internet?
- cloud computing services?
- cell phone services?
- data services?
- computer consulting services?
- engineering services?

Opinion 2

The general intent of Section 8 of S.B. 603 is to attribute sales, for purposes of calculating the taxpayer's Tennessee receipts factor, to Tennessee when Tennessee represents the location of the market for those sales. Section 8(i)(1)(C) would be construed within that framework. Because of the breadth of the types of services covered by this subsection, the Commissioner of Revenue would have considerable discretion to determine the manner of attribution through appropriate regulations.

Question 3

Under Section 8 of S.B. 603, are receipts derived from licensing intangibles (such as trademarks, trade names, etc.) used in connection with marketing tangible personal property attributed to the state where that tangible personal property is sold to the consumer or the state where the licensee is located?

Opinion 3

Under the terms of Section 8, receipts from the licensing of intangibles would not necessarily be attributed to either of the states identified in this question. Section 8 would attribute these receipts to the location of the purchaser of the tangible personal property in question.

Question 4

Section 8(i)(2) of S.B. 603 provides that "[i]f the state or states of assignment under subdivision (i)(1) cannot be determined, the state or states of assignment shall be reasonably approximated." How will this provision be administered and what will be the procedure for reviewing determinations made under this provision?

Opinion 4

As with all statutes establishing taxes administered by the Commissioner of Revenue, the Commissioner will possess the authority to determine when and how to invoke this provision, both through rulemaking and through the general functions necessary to administer the franchise and excise taxes. Those determinations will be subject to judicial review through challenges filed by taxpayers in chancery court under Tenn. Code Ann. §§ 67-1-1801, et seq.

Question 5

If Section 5 of S.B. 603 is adopted, is there any need for the excise tax provisions requiring intangible expenses to be added back to a taxpayer's taxable income or to not be deducted without the Commissioner's prior approval (Tenn. Code Ann. §§ 67-4-2006(b)(1)(K) and 67-4-2006(b)(2)(N)) and, if not repealed, would those provisions pose a risk of multiple taxation?

Opinion 5

The provisions in question are not necessarily duplicative, and current law forecloses any risk of multiple taxation should both provisions be enacted.

ANALYSIS

Question 1 – Economic Nexus

Section 5 of S.B. 603 would add the following definition of "substantial nexus in this state" to Tenn. Code Ann. § 67-4-2004, the definitional section for the franchise and excise tax statutes:

( ) "Substantial nexus in this state" means any direct or indirect connection of the taxpayer to this state such that the taxpayer can be required under the Constitution of the United States to remit the tax imposed under this part and part 21 of this chapter. Such connection includes, but is not limited to, the following:

(A) The taxpayer is organized or commercially domiciled in this state;

(B) The taxpayer owns or uses its capital in this state;

(C) The taxpayer has systematic and continuous business activity in this state that has produced gross receipts attributable to customers in this state;

(D) The taxpayer licenses intangible property for use by another party in this state and derives income from that use of intangible property in this state; or

(E) The taxpayer has bright-line presence in this state. A person has bright-line presence in this state for a tax period if any of the following applies:

(i) The taxpayer's total receipts in this state during the tax period, as determined under § 67-4-2012, exceed the lesser of five hundred thousand dollars ($500,000) or twenty-five percent (25%) of the taxpayer's total receipts everywhere during the tax period;

(ii) The average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period, as determined under § 67-4-2012, exceeds the lesser of fifty thousand dollars ($50,000) or twenty-five percent (25%) of the average value of all the taxpayer's total real and tangible personal property; or

(iii) The total amount paid in this state during the tax period by the taxpayer for compensation, determined under § 67-4-2012, exceeds the lesser of fifty thousand dollars ($50,000) or twenty-five percent (25%) of the total compensation paid by the taxpayer;

Section 7 of the bill would amend Tenn. Code Ann. § 67-4-2007(a) to read: "All persons, except those having not-for-profit status, doing business in *this state and having substantial nexus in this state shall*, without exception other than as provided in this part, pay to the commissioner, annually, an excise tax." (Emphasis added.)[1] The purpose of the addition of "substantial nexus" to Tenn. Code Ann. § 67-4-2007(a) is thus to explicitly bring within the scope of the excise tax any business entities engaging in the practices described in Section 5.

[1] The emphasized language replaces the word "Tennessee." Section 10 of S.B. 603 would make a similar change to the tax-imposing section of the franchise tax statute, Tenn. Code Ann. § 67-4-2105(a). Sections 2 and 4 as well as section 16 of the bill would also add the "substantial nexus" concept to the operation of the business and sales and use taxes, respectively, but those provisions are not implicated by this request.

More broadly, "substantial nexus" is a concept rooted in the Commerce Clause of the United States Constitution. The Commerce Clause authorizes Congress to "regulate Commerce with foreign Nations, and among the several States," U.S. Const. art. I, § 8, cl. 3. The United States Supreme Court has long interpreted the Commerce Clause to have a negative implication that "prohibits discrimination against interstate commerce and bars state regulations that unduly burden interstate commerce." *Quill Corp. v. North Dakota*, 504 U.S. 298, 313 (1992). This negative implication is also known as the Dormant Commerce Clause. *See id*. at 209. Under the Dormant Commerce Clause, courts "will sustain a tax against a Commerce Clause challenge so long as the 'tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.'" *Id*. at 311 (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)). *See also Arco Bldg. Sys. v. Chumley*, 209 S.W.3d 63, 69 (Tenn. Ct. App. 2006) (*perm. app. denied*). "Substantial nexus" is thus the first-prong of a four-part test for determining whether a state may impose a tax under the Commerce Clause.

The United States Supreme Court's most recent interpretation and application of the substantial nexus requirement was in *Quill*, which addressed whether companies soliciting sales in a state in which they had no physical presence should be required to collect and remit sales and use taxes in those states. Though the *Quill* Court agreed that its more recent Commerce Clause rulings "signaled a 'retreat from the formalistic constrictions of a stringent physical presence test in favor of a more flexible substantive approach,'" 504 U.S. at 314 (quoting lower court opinion at 470 N.W.2d 203, 214 (N.D. 1991)), it nevertheless decided not to overturn a safe harbor from sales and use tax requirements established in *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), because it found value in "a bright-line rule in the area of sales and use taxes," 504 U.S. at 316, and because *Bellas Hess* had "engendered substantial reliance" on the part of taxpayers. *Id*. at 317.

In *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), the taxpayer challenged its liability for Tennessee's franchise and excise taxes on the grounds that its lack of physical presence in Tennessee failed to satisfy substantial nexus despite its conduct of a credit card business with Tennessee customers. Our Court of Appeals noted that, under *Quill*, "physical presence is required in order to satisfy the substantial nexus requirement of *Complete Auto*." *Id*. at 839. Finding that "[t]he only real issue" in the case was thus whether the case could be distinguished from *Quill*, the court found "no basis for concluding that the analysis should be different . . . for franchise and excise taxes," *id*., found the taxpayer to have no meaningful physical presence in Tennessee, *id*. at 840-42, and held that the taxpayer was not subject to tax in Tennessee.

Since *J.C. Penney*, our appellate courts have taken an increasingly broader view of nexus. In *America Online, Inc. v. Johnson*, 2002 WL 1751434 (Tenn. Ct. App. 2002), the Court of Appeals found that the taxpayer could be subject to taxation in Tennessee under *Quill* and *Complete Auto* because of "a substantial number of businesses operating in this state helping make the AOL service available to Tennessee customers," even though AOL itself had no offices, employees, or real property in the state.[2] 2002 WL 1751434 at *3. In reaching this conclusion, the court addressed the *J.C. Penney* decision and more narrowly summarized the state of the law as providing that "the only situation where we know that a substantial nexus does not exist is where the only contact with the state is by the Internet, mail and common carriers."[3] *Id*. In *Arco*, the Court of Appeals upheld the imposition of sales and use taxes against an out-of-state taxpayer that sold buildings to Tennessee customers while contracting with third-party manufacturers to actually construct the buildings and deliver them to the Tennessee customers. The *Arco* Court relied on those manufacturers carrying on activities in Tennessee on Arco's behalf to establish a physical presence. *See Arco*, 209 S.W.3d at 74-75 (citing *Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232 (1987), and *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960)). And in *Scholastic Book Clubs, Inc. v. Farr*, 373 S.W.3d 558 (Tenn. Ct. App. 2012), the Court of Appeals declined to grant the *Quill* safe-harbor protection to the taxpayer because its connection to Tennessee was not limited to contact with customers through the mail or common carrier since it relied on Tennessee schools and teachers to facilitate sales to Tennessee customers. Taken together, these cases evince a broader understanding of substantial nexus, one that is not limited to a strict definition of physical presence but instead looks to "whether substantial business activities 'have been carried on in the taxing state on the taxpayers' behalf,'" *Arco*, 209 S.W.3d at 73, beyond the bright-line contours of the *Quill* safe harbor.

Around the country, a theory of "economic nexus" has developed in cases applying other states' equivalents of Tennessee's franchise and excise taxes to taxpayers without a physical presence in those taxing states. "Under an economic nexus theory, jurisdiction to tax exists if an out-of-state corporation avails itself of the benefits of the economic market of a state and without regard to that corporation's physical presence in the state." Walter Hellerstein, *State Taxation* ¶ 6.31 (3d ed. 2014). This approach has been followed in several states.[4] In relying on economic

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[2] The court noted that the "the record [was] not developed to a point of clarity" and remanded the case for further proceedings with the proviso that the material already in the record showed AOL's Tennessee connections to be more than "inconsequential or of only slight significance." *America Online*, 2002 WL 1751434 at *3-4.

[3] The *AOL* Court cited *Bellas Hess* and *Quill* for that proposition, but even that narrow conclusion has been drawn into question by one United States Supreme Court Justice's recent admonition that

> it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier. It should be left in place only if a powerful showing can be made that its rationale is still correct. The instant case does not raise this issue in a manner appropriate for the Court to address it. It does provide, however, the means to note the importance of reconsidering doubtful authority. The legal system should find an appropriate case for this Court to reexamine *Quill* and *Bellas Hess*.

Direct Mktg. Ass'n v. Brohl, 135 S. Ct. 1124, 1135 (Kennedy, J., concurring).

[4] *See, e.g., Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993) (imposing tax on out-of-state intangible holding company that licensed trademarks for use by affiliate in South Carolina); *General Motors v. Seattle*, 25 P.3d 1022, 1028 (Wash. Ct. App. 2001) (declining "to extend *Quill*'s physical presence requirement" to a tax on "the privilege of engaging in business within the City of Seattle" because the taxpayers "certainly exploit the market in the City, regardless of where they are physically located"); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004) (rejecting the contention that "physical presence is the *sine qua non* of a state's jurisdiction to tax under the Commerce Clause for purposes of income and franchise taxes"); *Tax Comm'r of W. Virginia v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 234 (W.V. 2006) (upholding tax under economic nexus theory because that theory "examin[es] the degree to which a company has exploited a local market"); *MBNA Am. Bank, N.A. v. Ind. Dep't of*

nexus principles to authorize the taxation of out-of-state taxpayers, these courts have often expressly disregarded or rejected the reasoning of *J.C. Penney*.[5] And, contrary to *J.C. Penney*, the courts in these cases have repeatedly interpreted the holding in *Quill* to apply to only sales and use taxes.[6]

Certain portions of S.B. 603's definition of "substantial nexus" would cover taxpayers that may have no physical presence within Tennessee and would come within the province of economic nexus.[7] In the light of the foregoing authorities from both Tennessee and other states, any assertion that S.B. 603's definition of "substantial nexus" would fail to meet the substantial nexus prong of *Complete Auto* would appear to be a minority opinion. Certainly the contrary assertion—that the Commerce Clause permits Tennessee to tax companies falling within S.B. 603's definition of substantial nexus—is defensible under the United States Constitution.

Question 2 – Determination of Location of Delivery

Section 8(i)(1)(C) of S.B. 603 provides that, for purposes of calculating the taxpayer's Tennessee sales factor, sales of services are "in this state . . . if and to the extent the service is delivered to a location in this state." You have asked how this provision would be applied to several types of services. The categories of services identified (services provided over the Internet, cloud computing services, cell phone services, data services, computer consulting services, engineering services) are very broad, and the particular circumstances of each service provider within these categories might affect the location-of-delivery analysis. Additionally, because S.B. 603 has not yet been passed, the Department of Revenue has not yet had the opportunity to adopt rules and regulations that may be necessary to implement or administer § 8.

Without having the benefit of pertinent rules and regulations, this Office is unable to apply § 8 of S.B. 603 to a host of broadly-stated factual circumstances. Such an effort would run the risk of unduly interfering with the rulemaking authority vested in the Commissioner of Revenue.

State Revenue, 895 N.E.2d 140, 144 (Ind. T.C. 2008) (following the West Virginia Supreme Court's economic-presence rationale from 640 S.E.2d 226); *Capital One Bank v. Mass. Comm'r of Revenue*, 899 N.E.2d, 85-86 (Mass. 2009) (following the West Virginia Supreme Court's economic-presence rationale from 640 S.E.2d 226 and concluding that "the concept of 'substantial nexus' is more elastic than 'physical presence'").

[5] *See, e.g. A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 196 n.9 (N.C. Ct. App. 2004); *Tax Comm'r of W. Virginia v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 232 (W.V. 2006); *MBNA Am. Bank, N.A. v. Ind. Dep't of State Revenue*, 895 N.E.2d 140, 144 (Ind. T.C. 2008).

[6] *See, e..g., A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194-95 (N.C. Ct. App. 2004) (describing the "important distinctions between sales and use taxes and income and franchise taxes"); *see also Lamtec Corp. v. Dep't of Revenue*, 215 P.3d 968, 974 (Wash. Ct. App. 2009) ("A close reading of *Quill* reveals that its language supports those courts that have limited *Quill* to cases involving sales and use taxes."); *Geoffrey Inc. v. Mass. Comm'r of Revenue*, 899 N.E.2d 87, 94-95 (Mass. 2009) ("The Supreme Court's decision in *Quill* discussed a 'physical-presence' requirement under the commerce clause only in the context of sales and use taxes.").

[7] Subsections (C), (D), and (E)(1) could potentially apply to such a taxpayer.

Question 3 – Licenses of Intangibles

The next question is how receipts derived from licensing intangibles (such as trademarks, trade names, etc.) used in connection with marketing tangible personal property would be attributed under § 8 of S.B. 603. Subsection (i)(1)(D)(i) addresses the licensing of intangible property. That subsection provides that "intangible property utilized in marketing a good or service to a consumer is considered used in this state if that good or service is purchased by a consumer who is in this state." Section 8 of S.B. 603 would thus attribute receipts from the licensing of an intangible used in the marketing of tangible personal property to Tennessee if the purchaser of the good being sold is located in Tennessee.

Question 4 – Reasonable Approximation

Section 8(i)(2) of S.B. 603 provides that, "[i]f the state or states of assignment under subdivision (i)(1) cannot be determined, the state or states of assignment shall be reasonably approximated." You have asked how this provision will be administered and what procedures will be followed in reviewing determinations made under it.

Should § 8 of S.B. 603 be enacted it would become part of the excise tax law, the "supervision and collection" of which "is under the direction of the department of revenue." Tenn. Code Ann. § 67-4-2003(a). The Commissioner of Revenue "is vested with power to prescribe rules and regulations not inconsistent with law." Tenn. Code Ann. § 67-1-102(a). It is thus the Commissioner of Revenue who, as an initial matter, would be empowered to determine how best to construe and apply § 8(i)(2) if it were adopted.[8]

The Commissioner's determination of when and how to invoke the "reasonable approximation" provision could result in either an assessment against the taxpayer of unpaid franchise and excise taxes or in the denial of a refund claim made by the taxpayer on the basis of a reasonable-approximation claim. Senate Bill 603 makes no provision for a specific review of these decisions, and so the general laws and procedures pertinent to the Department of Revenue would necessarily apply. Under those procedures, in the event of either an assessment or the denial of a refund claim, the taxpayer would have the opportunity to file suit in the appropriate chancery court under the procedures established by Tenn. Code Ann. §§ 67-1-1801, *et seq*. Under those procedures, the standard of review is *de novo* in the chancery court. Tenn. Code Ann. § 67-1-1802(c)(2). In proper judicial challenges to actions taken by the Commissioner, those courts will rely on basic canons of construction, the experience of states with similar statutes (*see, e.g.*, Code of Ala. § 40-27-1, art. IV, § 17), and the appropriate deference accorded to the Commissioner's construction of statutes committed to his or her administrative care. *See, e.g., Covington Pike*

[8] Of course, the proper attribution of sales other than sales of tangible personal property is necessary to determine the receipts factor under Tenn. Code Ann. §§ 67-4-2012(g) and 67-4-2111(g). Any taxpayer required to apportion earnings or net worth under the excise or franchise tax would therefore be required—if § 8 were adopted—to attribute those sales under § 8 of S.B. 603 in order to calculate its receipts factor (on which the overall apportionment factor and ultimately Tennessee tax liability are, in part, based). In the first instance, then, the taxpayer must make this determination in reporting and paying franchise and excise tax. But as with any tax administered by the Commissioner of Revenue, the Commissioner has the power to audit, determine liability, and make assessments of unpaid taxes. *See generally* Tenn. Code Ann. § 67-1-102. The execution of these responsibilities—in conjunction with rulemaking, if any—would result in the Commissioner initially determining how to apply these provisions.

Toyota, Inc. v. Cardwell, 829 S.W.2d 132, 134 (Tenn. 1992) (holding that "[i]n the absence of a clear showing that a rule is arbitrary or contrary to statute, a court should not substitute its judgment for the Commissioner's").

Because this bill has not yet become law, the Commissioner of Revenue has not adopted rules or regulations to administer it, and the courts of this State have had no opportunity to apply these provisions to real cases and controversies. Until such developments occur, it would be inappropriate for this Office to attempt to superintend the Commissioner's statutory responsibility to administer this law.

Question 5 – Relationship Between Economic Nexus and Intangible Expense Add-back

The last question is whether the adoption of S.B. 603's "economic nexus" provisions (discussed above under Question 1) would obviate the need for certain provisions in the excise tax statute that require a taxpayer to add back to net earnings or losses certain intangible expenses and that prohibit the deduction of certain intangible expenses without the prior approval of the Commissioner of Revenue. You have also asked whether there would be a risk of multiple taxation if both these provisions and the economic nexus provisions of S.B. 603 are given simultaneous effect.

Tennessee Code Annotated § 67-4-2006(b)(1)(K) provides that "[a]ny otherwise deductible intangible expense paid, accrued or incurred in connection with a transaction with one or more affiliates" be added back to a taxpayer's net earnings or losses. Tennessee Code Annotated § 67-4-2006(b)(2)(N)(i) provides that only an "intangible expense, or portion thereof, that is paid, accrued or incurred in connection with a transaction with one (1) or more affiliates" that "did not have as its principal purpose the avoidance of the tax levied" may be subtracted from net earnings and losses, and then only if the taxpayer applies for and the Commissioner of Revenue approves the deduction.

These provisions are specifically designed to thwart tax-avoidance gambits such as the one at issue in *Geoffrey*.[9] Under these statutes, the parent of such an intangible holding company is required to add back to its net earnings any intangible expenses—if they were otherwise deductible—paid to the intangible holding company and is not permitted to deduct those expenses unless it demonstrates to the Commissioner of Revenue that the expenses were not merely an artifice designed to shield some of the parent's earnings from taxation in Tennessee. Based on the economic-nexus jurisprudence discussed in response to Question 1, it is possible that some of the provisions in the "substantial nexus" definition of § 5 of S.B. 603 would require an intangible-

[9] In *Geoffrey*, Toys R Us created an intangible-holding-company subsidiary, the taxpayer, to own various trademarks and trade names. The taxpayer then licensed the right to use those marks back to Toys R Us for use in a variety of states, including South Carolina. In return, Toys R Us paid Geoffrey a royalty of one percent of its net sales. Though Toys R Us did business in South Carolina, Geoffrey had no physical property or employees there. *See Geoffrey*, 437 S.E.2d at 15-18. The goal was to shift earnings—in the form of the royalty payments—from Toys R Us (taxable in states like South Carolina) to Geoffrey (organized in Delaware, which has no corporate income tax, and which would not be taxable in South Carolina but for the economic-nexus theory discussed in response to Question 1).

Two *Geoffrey* cases—the original from South Carolina and a later iteration from Massachusetts—are discussed in the response to Question 1.

holding-company subsidiary to pay excise tax in Tennessee.[10] In that event, the *Geoffrey*-style structure would not remove some of the parent's earnings from taxation in Tennessee but would simply shift them from the parent's return to that of the intangible-holding-company subsidiary with the latter paying excise tax on an apportioned share of those earnings.

In spite of the similar goals of S.B. 603's economic nexus provisions and Tenn. Code Ann. §§ 67-4-2006(b)(1)(K) and 67-4-2006(b)(2)(N) in some contexts,[11] both still appear necessary to thwart certain tax-avoidance schemes. For example, a *Geoffrey*-style company would often have a smaller apportionment ratio than its affiliate that has a physical presence in Tennessee because its apportionment factors for property and payroll would be zero. Only if the royalty payment were especially high would its ratio outstrip that of its affiliate physically present in Tennessee.

But as the request indicates, applying both economic nexus to tax an intangible holding company and the intangible expense add-back provisions to require a physically-present affiliate to add its royalty payments back to net earnings would result in both companies paying excise tax on the Tennessee portion of the same net earnings. This could implicate the issue of multiple taxation of those earnings. Like the substantial nexus requirement, the multiple taxation doctrine is an outgrowth of the United States Supreme Court's interpretation of the limitations imposed by the dormant Commerce Clause upon the taxing power of the states. Arising originally in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938), the doctrine of multiple taxation is implicated "whenever one State's act of overreaching combines with the possibility that another State will claim its fair share of the value taxed: the portion of value by which one State exceeded its fair share would be taxed again by a State properly laying claim to it." *Okla. Tax Comm'n v. Jefferson Lines*, 514 U.S. 175, 184-85 (1995).[12] This is similar to the second prong of *Complete Auto* requiring "fair apportionment," the "central purpose" of which "is to ensure that each State taxes only its fair share of an interstate transaction." *Goldberg v. Sweet*, 488 U.S. 252, 260-61 (1989). The Supreme Court has said that "[t]his principle of fair share is the lineal descendant of *Western Live Stock*'s prohibition of multiple taxation." *Id*. at 184. The interaction of S.B. 603's economic nexus provisions and the already-enacted intangible-expense add-back requirements would thus pose constitutional difficulties if it resulted in any unfair apportionment of earnings to Tennessee.

However, this potential problem is already addressed by existing law. Tennessee Code Annotated § 67-4-2006(b)(2)(N)(i) provides that the Commissioner of Revenue

> shall approve any application for the deduction of any intangible expense, or portion thereof, that is

[10] That would occur most directly through § 5(D), covering the licensing of "intangible property for use by another party in this state and deriv[ing] income from that use of intangible property in this state." That section describes the *Geoffrey* fact pattern.

[11] The scope of the proposed definition of "substantial nexus" would cover many more taxpayers than come within the coverage of the intangible expense add-back statutes alone.

[12] Congress, acting under its positive grant of power under the Commerce Clause, overruled by statute the specific holding in *Jefferson Lines*. *See Jalbert Leasing, Inc. v. Mass. Port Auth.*, 449 F.3d 1, 3 (1st Cir. 2006). While the specific holding in *Jefferson Lines* thus no longer applies, the case remains a valid expression of Dormant Commerce Clause doctrine in a general sense.

> . . .
>
> (c) Paid, accrued, or incurred to an affiliate doing business in, or deriving income from, a state that imposes a tax on or measured by net income and, under that state's laws, the affiliate is subject to an income tax in that state.

Under this provision, an intangible holding company subject to taxation in Tennessee through economic nexus would qualify as a "an affiliate doing business in . . . a state that imposes a tax on or measured by net income," with that state being Tennessee. The royalty-paying taxpayer would thus have the right to have its intangible expense deducted to the extent provided in Tenn. Code Ann. § 67-4-2006(b)(2)(N)(i)(c). This provision would head off any concern that imposing tax on an intangible holding company while also adding that company's royalty receipts back to the net earnings of the affiliate payer of the royalties would result in an unfair apportionment of earnings or in multiple taxation.[13]

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[13] But note that Tenn. Code Ann. § 67-4-2006(b)(2)(N) would be rewritten by Amendment No. 3 (H.A. 469) to the House version of S.B. 603, H.B. 644, which would replace § 2006(b)(2)(N) with the following language:

> (N) Any intangible expense paid, accrued, or incurred in connection with a transaction with one (1) or more affiliates, if the following criteria are met:
>
> (i) The intangible expense has been disclosed in accordance with subdivision (d)(1); and
>
> (ii) If the affiliate to whom the expense has been paid, accrued, or incurred is required to be registered and pay the tax imposed by this part, the affiliate is in fact registered and paying the tax.

In the event that an intangible-holding-company recipient of royalty payments would be subject to Tennessee's franchise and excise tax through the economic-nexus provisions of S.B. 603/H.B. 644, then any risk of multiple taxation would be foreclosed because proposed § (N)(ii), under which that recipient would be "required to be registered and pay" the excise tax, would allow the royalty-paying taxpayer to subtract the intangible expense from its net earnings.

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