

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 04-31**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of the business tax deduction set forth in Tenn. Code Ann. § 67-4-711(a)(5) for payments to subcontractors.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[THE TAXPAYER] provides operations, maintenance, and repair services to the [A TENNESSEE COMPANY]. The taxpayer makes payments to service contractors. The particular service contractors that relate to the subject of the ruling have **not** been

classified in Classification 4(A)¹ by the county clerk and do not provide construction services.

QUESTION

Is the taxpayer entitled to a deduction from the business tax base for amounts paid to service contractors not in Classification 4(A), under circumstances that are described more fully in the following?

RULING

With respect to a particular payment, the taxpayer may claim a deduction only if **both** of the following conditions are met.

- (1) The payment must be for the services described in Tenn. Code Ann. § 67-4-711(a)(5). Such a payment could be to a person that is a Classification 4(A) business, or it could be to a person classified in one of the other classifications (due to that person's dominant business activity being in another classification) but who performs these services.
- (2) The taxpayer must have receipts arising from those same services.

If either of the above conditions is not met, the taxpayer may not claim the deduction for that payment.

ANALYSIS

Applicable Statute and Rule

Tenn. Code Ann. § 67-4-711 reads in pertinent part:

(a) In computing tax, there may be deducted from the measure of tax the following items:

* * * *

(5) Amounts actually paid during the business tax period to subcontractors or amounts actually paid during the business tax period to other persons for rendering exterminating services, for installing personal property, for constructing, building, erecting, repairing, grading, excavating, drilling, exploring, testing, or adding to any building, highway, street, sidewalk, bridge, culvert, sewer, irrigation or water

¹ A letter from the county clerk to the taxpayer attached to the ruling request uses this term to denote those subcontractors that the clerk states payments to may be deducted. It is presumed that "Class 4A" means the contractors' dominant business activity consists of the activities described in Tenn. Code Ann. § 67-4-708(4)(A). This ruling will use the term "Classification 4(A)" to describe one performing the activities listed in Tenn. Code Ann. § 67-4-708(4)(A).

system, drainage or dredging system, levee or levee system or any part thereof, railway, reservoir, dam, power plant, electrical system, air conditioning system, heating system, transmission line, pipeline, tower, dock, storage tank, wharf, excavation, grading, water well, or any other improvement or structure or any part thereof;

(A) For a contractor to be eligible to claim the deduction, such contractor must advise the appropriate clerk of the name and address of the subcontracting firm and of the amount subcontracted; and

(B) Contractors shall not be required to provide any other information concerning subcontractors or other persons in order to claim this deduction;

The Commissioner has promulgated regulations with respect to the business tax. TENN. COMP. R. & REGS. 1320-4-5-.09(2) addresses the deduction previously mentioned, stating in pertinent part:

A contractor shall pay tax under Classification 4 of the Business Tax Act upon all receipts without any deductions except as specifically provided. ... Amounts actually paid during the business tax period to subcontractors or other persons for the services enumerated in T.C.A. §67-4-711(a)(5) may be deducted provided the contractor adequately identifies such persons by supplying the local collecting officers with the names and addresses of the subcontractors or other persons and of the amounts subcontracted or charged.

Only Payments for the Particular Services Described
in Tenn. Code Ann. § 67-4-711(a)(5) Are Deductible

The taxpayer suggests in its ruling request that payments to all persons that are “subcontractors” should be deductible pursuant to Tenn. Code Ann. § 67-4-711(a)(5), as well as payments to “other persons” who are not subcontractors but who perform the services listed in the exemption. The taxpayer suggests that subcontractors need not perform what it calls “construction services” in order for the payment to be deductible by the taxpayer.

The deduction allowed pursuant to Tenn. Code Ann. § 67-4-711(a)(5) is appropriately viewed as an exemption from taxation. *See Hutton v. Johnson*, 956 S.W.2d 484, 488 (Tenn. 1977) (stating that statutory provisions that operate to negate, in part, other statutory provisions which impose tax should be construed as exemptions). The rules of statutory construction for exemptions were described by the Court of Appeals in *American Cyanamid v. Huddleston*, 908 S.W.2d 396 (Tenn. Ct. App. 1995), as follows:

Tax exemption statutes are to be construed against the taxpayer and will not be implied. ...

Every presumption is against exemption, and any well founded doubt defeats a claimed exemption. ...

The burden is upon the taxpayer to establish a claimed exemption.
...(Citations omitted)

Id. at 400. Therefore, the deduction applies only if the statute clearly allows it.

Both the statute and rule use language in which the word “subcontractors” and the phrase “other persons” are followed by words describing specific services, which are services ordinarily thought of as “construction services” (as well as exterminating services). Further, the list of services in Tenn. Code Ann. § 67-4-711(a)(5) is identical to that in Tenn. Code Ann. § 67-4-708(4)(A), which sets out the business activities that fall in Classification 4(A) for classification purposes.² It is obvious that the deduction provided by Tenn. Code Ann. § 67-4-711(a)(5) is intended to cover those activities listed in Tenn. Code Ann. § 67-4-708(4)(A) and no other activities. Any other interpretation of the deduction statute would, in effect, permit virtually unlimited deductions to taxpayers, since many payments for services are made pursuant to a contract and might be described as payments to “subcontractors.”

It Is the Nature of the Payment to the Subcontractor
and Not the Business Tax Classification of the
Subcontractor That Determines if the Payment Is Deductible

Assuming a payment is for the services enumerated in the statute and rule, the question of whether the deduction is limited to payments to persons who are classified in Classification 4(A) remains.

In order to limit the deduction to payments to persons who are classified in Classification 4(A), it would first be necessary to determine that a taxpayer’s particular classification in fact “labels” that taxpayer for all purposes under the Business Tax Act. Next, it would be necessary to conclude that the legislature’s purpose in using the word “contractor(s)” in Tenn. Code Ann. § 67-4-711(a)(5)(A) and (B) was to limit this particular deduction to persons “labeled” as contractors by their classification in Class 4(A). Note that no other deduction enumerated in Tenn. Code Ann. § 67-4-711 contains language that might limit a deduction to a particular class of taxpayer.

The early business tax case, *Hermitage Memorial Gardens, et. al. v. Dunn*, 541 S.W.2d 147 (Tenn. 1976), offers much help in resolving the “label” issue. In discussing the term “dominant business activity” the Court said:

The dominant business activity of a taxpayer is relevant only in determining which of the classifications specified in Section 67-5805

² The business tax statute classifies businesses into various classifications, based on the taxpayer’s dominant business activity. The tax rate and tax year depend on the classification in which the taxpayer is classified. See Tenn. Code Ann. § 67-4-708.

[now Section 67-4-708] applies to him, which in turn, determines the rate of tax applicable to him and the particular due date of the tax. (Underscoring added.)

Id. at 149.

To use the classification to “label” a person as a farmer, beer wholesaler, hardware store operator, used car salesman, electronics salesman, or the like would be to use the classification for a purpose other than determining the tax rate and due date and would be contrary to the holding in *Hermitage Memorial Gardens, supra*.

Therefore, the classification of the person to whom the subcontract payment is made is not significant. If the payment is for the activities described, it may be deducted, if the payment is deductible pursuant to the remaining part of this analysis.³

While a Taxpayer Need Not Be Classified in Classification 4(A),
It Must Have Receipts Arising from Activities Listed in Classification 4(A)
in Order to Claim the Deduction

Finally, following the above reasoning, regardless of the classification it is in, a taxpayer should be able to claim the deduction for payments to subcontractors and others for activities enumerated in Tenn. Code Ann. § 67-4-711(a)(5) and TENN. COMP. R. & REGS. 1320-4-5-.09(2) and 1320-4-5-.12(1)(e), despite apparent limiting language in the statute and the rule describing the deduction, i.e., the reference to “contractor(s)” and the “contractor payments to subcontractors.” The term “contractors” cannot be limited to those persons whose contracting activities result in their being classified in Classification 4(A).

However, the reference to “contractor(s)” and “contractor payments to subcontractors” in the statute and the rule, respectively, requires a construction that permits the deduction for payments to subcontractors only to persons receiving income from activities as a contractor, that is those activities enumerated in Classification 4(A). Otherwise, the requirement for deductibility of these payments as described in TENN. COMP. R. & REGS. 1320-4-5-.09(2) and 1320-4-5-.12(1)(e) would not be met; that is, the amount of the claimed deduction would not have been included in gross sales. It does not appear, from the facts given, that the taxpayer has such sales.

³ For example, the payment could be to a business whose dominant business activity is of a lumber dealer, which would place the business in Classification 1, but that also has a construction division that performs activities that, if those activities were the dominant business, would place the business in Classification 4(A).

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APPROVED: Loren L. Chumley
Commissioner

DATE: 9/20/04