

**IN THE COURT OF APPEALS OF TENNESSEE
MIDDLE SECTION AT NASHVILLE**

FILED

September 25, 1996

**Cecil W. Crowson
Appellate Court Clerk**

AABAKUS, INCORPORATED,)
)
Plaintiff/Appellant,)
)
VS.)
)
)
)
JOE B. HUDDLESTON,)
Commissioner of Revenue,)
State of Tennessee,)
)
Defendant/Appellee.)

Davidson Chancery
No. 93-2739-II

Appeal No.
01-A-01-9505-CH-00215

APPEAL FROM THE CHANCERY COURT FOR DAVIDSON COUNTY
AT NASHVILLE, TENNESSEE

THE HONORABLE C. ALLEN HIGH, CHANCELLOR

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**AFFIRMED IN PART; REVERSED IN PART;
AND REMANDED**

WILLIAM C. KOCH, JR., JUDGE

OPINION

This appeal involves the business tax liability of a human resource support service. The Tennessee Department of Revenue treated all amounts paid by the service's clients as gross receipts and assessed the service \$40,867 for unpaid taxes, penalties, and interest. The service paid the disputed amount and then filed suit in the Chancery Court for Davidson County asserting that it was exempt from taxation on the ground that it was merely providing bookkeeping services or, in the alternative, that its gross receipts consisted only of the service fees collected from its clients. The trial court granted the department's motion for summary judgment, and this appeal followed. We have determined that the service was not exempt from taxation but that its gross receipts should be limited to the service fees collected from its clients. Accordingly, we modify the judgment.

I.

Aabakus, Inc. provides human resource management services¹ to small businesses. Aabakus and its clients enter into "client service agreements" in which Aabakus agrees to perform the services desired by the client in return for a lump sum client service fee. Aabakus becomes the "employer" on paper of its clients' employees, but the employees continue to perform the same work and remain under the client's direct supervision and control. During the audit period, Aabakus had approximately twenty clients employing a total of approximately 200 employees.

Aabakus's clients typically compute the number of hours worked and the rate of pay for each of their employees as payday approaches. They provide this information to Aabakus along with a check or wire transfer to cover the gross payroll, all applicable taxes and insurance premiums, and Aabakus's service fee. After receiving these funds, Aabakus prepares the payroll checks, pays the taxes

¹These services include: (1) payroll processing and administration, (2) payment of employment-related taxes, (3) filing annual reports, (4) coordinating COBRA compliance and group medical insurance coverage, (5) coordinating worker's compensation coverage, (6) developing and coordinating an employee policy manual, and (7) providing guidance and assistance with respect to administrative hearings, appeals, and labor disputes.

and insurance premiums, and completes and files the necessary reports for each client. The funds remaining after all the checks are distributed and other related payments are made represents Aabakus's service fee.

The Business Tax Division of the Department of Revenue audited Aabakus for the period from July 1, 1988 through December 31, 1990. The division took the position that all funds Aabakus received from its clients should be considered gross receipts, and accordingly on December 18, 1992, the Commissioner of Revenue issued Aabakus an assessment for \$40,867 in unpaid taxes, penalties, and interest. Aabakus paid the assessment plus additional accrued interest on June 15, 1993 and simultaneously filed a claim for a refund of \$42,081.42 on the grounds that its business was totally exempt from taxation under Tenn. Code Ann. § 67-4-708(3)(C)(viii) (1994). The commissioner denied the refund claim on July 9, 1993, and Aabakus then filed a timely petition for judicial review in the Chancery Court for Davidson County. The trial court granted the commissioner's motion for summary judgment, and this appeal ensued.

II.

Aabakus first asserts that it is exempt from paying business taxes because it is providing nothing more than "accounting, auditing, and bookkeeping services" which are exempt from taxation under Tenn. Code Ann. § 67-4-708(3)(C)(viii). We do not agree because the undisputed evidence demonstrates that Aabakus's dominant business activity is much more than mere accounting, auditing, and bookkeeping services.

A.

The standards for construing tax statutes are well understood. The words in the statute should be used in their natural and ordinary sense. *Nashville Golf & Athletic Club v. Huddleston*, 837 S.W.2d 49, 53 (Tenn. 1992). They should not be construed so as to extend or to limit the statute's meaning beyond the import of the language used. *Metropolitan Gov't v. Motel Sys., Inc.*, 525 S.W.2d 840, 841 (Tenn. 1975). Thus, a clear expression of legislative intent will generally be given effect as written. *Stratton v. Jackson*, 707 S.W.2d 865, 866 (Tenn. 1986).

Laws imposing a tax are strictly construed against the taxing authority. *National Gas Distribs., Inc. v. State*, 804 S.W.2d 66, 67 (Tenn. 1991). Thus, tax laws will not be extended by implication beyond the clear import of their language nor will their operation be enlarged to embrace matters not specifically included. *Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992). Conversely, exemptions are construed against the taxpayer. *AFG Indus., Inc. v. Cardwell*, 835 S.W.2d 583, 584-85 (Tenn. 1992). Taxpayers bear the burden of proving that they are entitled to an exemption, *Tibbals Flooring Co. v. Huddleston*, 891 S.W.2d 196, 198 (Tenn. 1994), and a well-founded doubt will be fatal to a claim for an exemption. *United Cannery, Inc. v. King*, 696 S.W.2d 525, 527 (Tenn. 1985).

The construction of a tax statute is a question of law for the courts. *Beare Co. v. Tennessee Dep't of Revenue*, 858 S.W.2d 906, 907 (Tenn. 1993). While a taxing agency's interpretation of a tax statute is persuasive, it is certainly not conclusive. *Moto-Pep, Inc. v. McGoldrick*, 202 Tenn. 119, 129, 303 S.W.2d 326, 330 (1957). Thus, when the facts are undisputed, the question of whether a taxpayer is entitled to an exemption is purely a question of law for the courts. *See Oak Ridge Hosp. of the Methodist Church, Inc. v. City of Oak Ridge*, 57 Tenn. App. 487, 490, 420 S.W.2d 583, 584 (1967).

B.

The Business Tax Act² is a component of Tennessee's scheme of privilege and excise taxes. It allows counties and incorporated municipalities to tax the privilege of "the making of sales by engaging in any . . . business activity enumerated . . . in § 67-4-708(1)-(3)." Tenn. Code Ann. § 67-4-704(a) (1994). Businesses are classified in Tenn. Code Ann. § 67-4-708 according to their "dominant business activity,"³ and these statutory classifications determine the rate and due date of the tax.

²Tenn. Code Ann. §§ 67-4-701 to -729 (1994 & Supp. 1996).

³A business's "dominant business activity" is that "business activity which is the major and principal source of gross sales." Tenn. Code Ann. § 67-4-702(a)(4) (1994).

Tenn. Code Ann. § 67-4-708(3)(C) declares generally that “making sales of services or engaging in the business of furnishing or rendering services” is a taxable privilege. The statute then lists fifteen service categories that are exempt from taxation. Tenn. Code Ann. § 67-4-708(3)(C)(i)-(xv). To further describe the services exempt from taxation, Tenn. Code Ann. § 67-4-708(3)(C) states that “[i]t is the legislative intent that the exceptions . . . shall include the sales of services by those businesses or establishments so described in the Standard Industrial Classification Index of 1972, including all supplements and amendments”

Tenn. Code Ann. § 67-4-708(3)(C)(viii) exempts “[a]ccounting, auditing, and bookkeeping services” from taxation. Aabakus argues that it is entitled to a total exemption from taxation under this section. In order to evaluate Aabakus's claim, we look to the Standard Industrial Classification Manual to determine the meaning of accounting, auditing, and bookkeeping services under that classification system. We must then determine whether there is any genuine dispute of material fact as to whether Aabakus fits under this category.

C.

The Standard Industrial Classification Manual (SIC) classifies business establishments by the type of economic activity they perform. Office of Management & Budget, Executive Office of the President, *Standard Industrial Classification Manual of 1987*, at 11, 699 (1987) [hereinafter *SIC of 1987*]. The manual was designed specifically for statistical purposes, *SIC of 1987, supra*, at 699, and thus classifies only those types of business establishments representing a significant part of the economy. *See SIC of 1987, supra*, at 11, 701. It has been amended and revised several times since 1972 in order to reflect the economy's changing industrial organization.⁴ *SIC of 1987, supra*, at 3.

The SIC classifications are based on the “primary” or “predominant” activity of the subject industries. *SIC of 1987, supra*, at 15. The activity in which a particular service industry is primarily engaged is determined by the value of the

⁴The SIC of 1972 was amended by a separately bound supplement issued in 1977. It has since been superseded by a completely revised edition published as the SIC of 1987. All references in this opinion are to the most current SIC of 1987.

receipts or revenues generated by the various activities of the business. *SIC of 1987, supra*, at 16. The activity generating the greatest relative share of “value added” is the business’s primary activity. *SIC of 1987, supra*, at 15. By classifying on this basis, a business which generates revenue from some incidental activity is not classified based upon that activity.

The SIC is first divided into major divisions representing the various sectors of our economy such as agriculture, manufacturing, or services. Each division is then broken down into major groups, industry groups, and finally specific industries by number. *SIC of 1987, supra*, at 12. For example, “Accounting, Auditing, and Bookkeeping Services” is industry number 8721 which is part of industry group number 872 by the same name. Industry group 872 lies in major group 87, “Engineering, Accounting, Research, Management, and Related Services,” under the division of services. *SIC of 1987, supra*, at 401-02.⁵

The manual does not provide additional information concerning the types of services intended to be included in industry number 8721. However, it identifies “payroll accounting service” as a specific example of such a service. By the same token, it indicates that other types of services would not be included in industry number 8721 by placing them in a different industry code number. For example, “employee leasing services” are included in industry code number 7363 (“Help Supply Services”) and “human resource consultants” and “personnel management consultants” are listed under industry code number 8742 (“Management Consulting Services”).

D.

Aabakus describes itself as a “rentable human resources department.” Susan G. Mitchell, the company’s chief executive officer, stated that Aabakus’s services include everything from the processing of payroll to the coordination of group benefits to the preparation of an employee policy manual for its clients. Although Ms. Mitchell calls herself a “paperwork junkie,” it is clear that Aabakus performs much more than simple accounting, auditing, and bookkeeping services.

⁵The SIC also contains many “miscellaneous” code numbers for services that cannot be readily classified under one of the existing industry codes. *SIC of 1987, supra*, at 12.

As a “rentable human resources department,” Aabakus provides a cafeteria benefit plan for its clients. While it processes the paperwork associated with these plans and collects the various premiums involved, it also meets with its clients’ employees to explain their benefits and is always accessible to answer employees’ questions. Any employee of a client may request Aabakus’s help in handling a benefit problem, such as unpaid medical benefit claims. Aabakus also acts as an administrator of the cafeteria benefit plan by monitoring costs and by determining when and how to change the benefits offered to the employees of its clients.⁶

Besides the administration of the benefit plans, Aabakus also guides its clients through worker’s compensation investigations. It helps them to file the necessary “first report[s] of injury” with the worker’s compensation carrier. Aabakus also provides its clients with a list of physicians with whom it has negotiated discounts for treatment of injured workers. Finally, Aabakus assists its clients in investigating questionable claims, thereby preserving a record to be consulted should the need arise.

Aabakus also attends unemployment hearings and labor board disputes with the managers of its clients. In this role, it guides its clients’ managers through the relevant procedures, and it also returns for the hearing and prepares the required paperwork. Ms. Mitchell stated that “[a] lot of times, [the client companies] just want comfort” at these hearings.

In addition, Aabakus maintains the employee records and prepares employee policy manuals for its clients. It also provides life, cancer, and disability insurance coverage at large group rates, and it makes available a 401(k) retirement plan, credit union memberships, and Sam’s Wholesale Club memberships to all its clients’ employees.

Ms. Mitchell does not dispute that Aabakus provides these services. In fact, all of the information about the company’s activities was included in her deposition. She simply asserts that Aabakus’s primary function is to perform accounting, auditing, and bookkeeping services for its clients. In this regard, Ms.

⁶For example, Aabakus added underwriting to its Blue Cross/Blue Shield medical plan to deny insurance coverage to new employees who have serious medical problems.

Mitchell notes that Aabakus prepares the payrolls and distributes all of the necessary third-party payments such as federal withholding, social security taxes, and any state taxes. Aabakus also prepares the required quarterly and annual reports.

E.

Since the facts of this case are undisputed, the question of whether Aabakus is entitled to a Tenn. Code Ann. § 67-4-708(3)(C)(viii) exemption from business taxes is purely a question of law. *Oak Ridge Hosp. of the Methodist Church, Inc. v. City of Oak Ridge*, 57 Tenn. App. at 490, 420 S.W.2d at 584. Thus, the issue is appropriate for disposition under summary judgment standards.

We have concluded that Aabakus is not entitled to take advantage of the exemption from business taxes under Tenn. Code Ann. § 67-4-708(3)(C)(viii). The service fee paid by each client is based upon all of the services performed or available to be performed by Aabakus. Thus, the accounting, auditing, and bookkeeping services cannot be separated from the other human resource functions performed. These are not separate activities generating a separate share of the “value added” by Aabakus’s business but rather are part-and-parcel of the entire service package performed by Aabakus. No single function or service can be viewed as incidental to the others.

Thus, Aabakus’s services are a combination of various SIC industry classifications. Since the SIC is designed to function as a statistical classification system for distinct industries, we have concluded that Aabakus would presently be classified, if at all, under one of the miscellaneous industry categories. Its functions are far broader than the mere “payroll accounting services” classified under SIC industry number 8721. The wealth of services it provides related to health and welfare benefit planning, if presently classifiable, appear to be more closely akin to management consulting included in industry code number 8742. Accordingly, as a matter of law, Aabakus is not entitled to a complete exemption from business taxes under Tenn. Code Ann. § 67-4-708(3)(C)(viii). Thus, we affirm the trial court’s order in this regard.

III.

Our inquiry is not yet complete even though we have determined that Aabakus is not entitled to a total exemption from taxation since its business entails more than simple accounting, auditing, and bookkeeping services. We must still determine what portion of the funds Aabakus receives from its clients is subject to taxation. Aabakus argues that only its service fee should be taxable. We agree.

A.

The business tax has been described as a “gross receipts” tax. *Stalcup v. City of Gatlinburg*, 577 S.W.2d 439, 440 (Tenn. 1978); *IBM Credit Corp. v. County of Hamilton*, 830 S.W.2d 77, 78 (Tenn. Ct. App. 1992). Regardless of the seeming breadth of this description, the assessment of business taxes is limited to the amount of sales made by a business. *See* Tenn. Code Ann. § 67-4-709(b)(3) (1994); Tenn. Comp. R. & Regs. r. 1320-4-5-.08(2) (1984). Thus, in order to determine the amount of taxes due, it is necessary to first determine the sales price of the services sold.

Tenn. Code Ann. § 67-4-702(a)(13) defines “sales price” as “the total amount for which . . . services rendered is sold . . . without any deduction therefrom on account of the . . . labor or service cost . . . or any other expense whatsoever.” *See also* Tenn. Comp. R. & Regs. r. 1320-4-5-.08(1). Aabakus asserts that the sales price of its services is the fee charged to its clients. The commissioner, on the other hand, maintains that Aabakus’s tax liability should be based on the entire dollar amount transferred to Aabakus by its clients each time payroll is due. Under the commissioner's theory, Aabakus’s absolute contractual obligation to pay over most of the funds received from its clients to third-parties is irrelevant.

Determining the meaning of “sales price” for purposes of the business tax act is a question of legislative intent. We are mindful that the General Assembly has the sole prerogative to create tax exemptions and that we cannot create them by judicial fiat. However, we must construe tax statutes as they are written. If the term “sales price” in Tenn. Code Ann. § 67-4-702(a)(13) includes only Aabakus’s

fee, then the additional funds Aabakus receives from its clients would not have been taxable in the first place. Rather than being exempted from taxation, these funds more properly should be considered as being excluded from taxation.⁷

B.

Aabakus provides personnel management services to small businesses. It does not provide simple bookkeeping services, nor does it supply its clients with permanent or temporary employees.⁸ Its client service agreements identify the services to be provided and the fee to be paid for these particular services. This fee does not include the funds that Aabakus must pay over to third-parties on its clients' behalf. Ms. Mitchell estimated that Aabakus's total receipts from its clients in 1993 was approximately eight million dollars and that only five hundred thousand dollars remained after all required third-party payments were made. The funds remaining represented the fee Aabakus earned for the services rendered to its clients.

Considering the statutory definition of "sales price" in Tenn. Code Ann. § 67-4-702(a)(13), we agree with Aabakus that the only amount taxable is that amount which remains after the clients' third-party payments are made. It is that percentage fee which represents the amount for which Aabakus's "services rendered is sold." Aabakus merely acts as a paying agent for its clients with respect to the rest of the funds received. Thus, the additional funds are not taxable under our state's business tax scheme.

IV.

⁷For the purpose of taxation, exclusions are items that were never in the taxing statute in the first place, while exemptions are items that would otherwise be subject to taxation but which have been removed by statute. *In re Twisteroo Soft Pretzel Bakeries, Inc.*, 21 B.R. 665, 667 (E.D. Pa. 1982); *Lancaster Labs., Inc. v. Commonwealth*, 631 A.2d 739, 741 n.1 (Pa. Commw. Ct. 1993).

⁸Aabakus's representations to the Department of Employment Security that its clients' employees are its employees does not necessarily transform them into Aabakus's employees. The test traditionally used to determine the existence of an employment relationship includes considering (1) the right to control the conduct of the work, (2) the power of termination, (3) the method of payment, (4) the freedom to select and hire other workers, (5) the furnishing of tools and equipment, and (6) the scheduling of the work. *Galloway v. Memphis Drum Serv.*, 822 S.W.2d 584, 586 (Tenn. 1991); *Stratton v. United Inter-Mountain Tel. Co.*, 695 S.W.2d 947, 950 (Tenn. 1985). When the limited facts in this record are examined in light of these factors, it appears that Aabakus's clients remain the employers-in-fact of their employees.

In summary, we find that Aabakus is subject to taxation under the Business Tax Act and that its tax liability should be based on the fees it charges for its personnel management services, not on the funds it receives but is contractually obligated to pay over to third-parties. Therefore, we remand the case to the trial court for the determination of the proper amount of taxes owed by Aabakus and the amount of any refund that may be due and for any other proceedings that may be required. We also tax the costs of this appeal to the Commissioner of Revenue.

WILLIAM C. KOCH, JR., JUDGE

CONCUR:

HENRY F. TODD, P.J., M.S.

SAMUEL L. LEWIS, JUDGE