2013 SINGLETON B. WOLFE MEMORIAL TAX CONFERENCE
TENNESSEE STATE TAX UPDATE

CURRENT STATE TAX DEVELOPMENTS
LEGISLATIVE, JUDICIAL AND ADMINISTRATIVE

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LEGISLATIVE CHANGES

2013 Legislative Changes

Consistent with its recent approach under the current administration, the General Assembly this year chose to focus in-depth on one or two areas of Tennessee tax law, rather than making relatively minor changes to a wide variety of tax provisions. In 2013, the General Assembly focused on significant revisions to Tennessee’s Business Tax and a possible overhaul of the procedures through which tax assessments can be challenged, ultimately adopting the former and deferring action on the latter. The General Assembly also, once again, deferred full implementation of the Streamlined Sales and Use Tax provisions (no surprise there!). Each of these legislative efforts are discussed below.

A. Business Tax Legislation

During last year’s legislative session, the Tennessee Department of Revenue introduced a bill late in the legislative session to dramatically change Tennessee’s Business Tax statutes.¹ This legislation followed the relatively recent change that allowed the Department of Revenue to administer the Business Tax. Ultimately, due to the timing of the bill and the controversy it created with many of its provisions, the Department withdrew its proposal. The Department renewed its efforts this legislative session seeking the aid of practitioners and, this time, succeeded in getting the Business Tax revisions it had attempted last session with certain key modifications to address the concerns of the business community. As discussed below, the Department’s authority to enforce the Business Tax is significantly increased under the new legislation with its new ability to directly levy the Business Tax, and more significantly, the Business Tax is imposed on a number of taxpayers that, at least arguably, were not subject to the tax under the prior Business Tax statutes if the taxpayer did not have a Tennessee business location.

Tennessee’s Business Tax is imposed on the gross receipts from business conducted in Tennessee. The tax is imposed at a relatively low rate, with the precise rate determined by the dominant business activity of a particular taxpayer. For years, the Business Tax was a purely local tax imposed and administered by the counties and municipalities in which business was conducted. Through legislation adopted in 2009, the Department took over responsibility for administering, collecting, and enforcing the Business Tax.

Under the legislation adopted in 2013, the Business Tax will become both a State-imposed and State-enforced tax. The State will impose the Business Tax at a uniform rate, regardless of the county in which a company conducts business. Cities will still be free to impose the Business Tax in addition to the State-imposed tax. Any city that chooses to do so must collect the tax at the uniform rate imposed by the State. Cities that currently impose the Business Tax at a lower rate are “grandfathered” in and allowed to continue to impose the tax at the reduced rate.

¹ T.C.A. §67-4-701 et seq. (the “Business Tax”).
The new legislation also expressly imposes the Business Tax on businesses that maintain a location outside Tennessee and make sales into Tennessee even if the businesses have no physical location in the state. Previously, taxpayers with no physical location in Tennessee had challenged attempts to impose the Business Tax on sales into the State by arguing that the tax is a location-based tax. Out-of-state businesses with no physical location in Tennessee have also raised Commerce Clause challenges. Most of these cases are now being settled by the Department.

The recently adopted legislation attempts to address these challenges by expressly making receipts derived from certain in-state activities performed by out-of-state businesses subject to the State-imposed Business Tax, with all such taxes paid to the State's general fund. The legislation now expressly adopts “market-based” sourcing by making the following activities subject to the Business Tax, even if the business conducting the activities does not have a physical location in Tennessee:

1. Performing any service in Tennessee, to the extent such service is received by a customer located in the state;

2. Leasing tangible personal property that is located in the state

3. Delivering tangible personal property to a buyer in Tennessee, when delivered by the seller in the seller’s own vehicle; and

4. Purchasing and subsequently selling tangible personal property in Tennessee in a wholly in-state transaction, where the purchase and subsequent sale are accomplished through the presence in this state of the seller’s employees, agents, or independent contractors acting on behalf of the seller.

Notably, these provisions only make sales of a service performed in Tennessee subject to the Business Tax “to the extent such service is received by a customer located in the state.” In a similar provision, the new legislation also provides that gross receipts from “sales of services that are received by customers located outside the state” are deducted from the “measure” of gross receipts subject to the Business Tax. Through these two recently adopted provisions, the General Assembly has made clear that market-based sourcing is used to source sales of services for purposes of Tennessee’s Business Tax, thereby avoiding the potential disputes and constitutional problems that had arisen under the prior law when services were performed in Tennessee for customers located in states across the country that is the subject of several pending audits.

The new legislation also continues the satellite television providers’ exemption from the Business Tax. Federal law prohibits satellite television providers from being subject to a locally imposed tax, but there is no such prohibition on a state-imposed tax. As a result, without an express exemption, satellite television would be subject to the state-imposed Business Tax under the new legislation. To remedy this issue and continue the exemption satellite television
received under the prior locally imposed Business Tax, the new legislation expressly exempts satellite television providers from the Business Tax.

B. Proposed Overhaul to Assessment Challenge Procedure

A bill was introduced at the beginning of this year’s legislative session that would have dramatically changed the way Tennessee tax assessments were challenged. Among other things, the bill would have created a separate tax tribunal to hear all tax disputes, with the decisions entered by that tribunal subject to immediate appellate review. While the proposed legislation had the ostensible and admirable goal of greater fairness and decreased expense in the tax review process, the legislation was criticized by the Department and by many taxpayers and tax practitioners due to a number of questions left unanswered and potential constitutional problems with the new system that would have been created under the proposed legislation.

As a result, the Department worked with the sponsor of the bill to prepare an amendment that would have made far less sweeping changes to the current procedure. Under the amendment, there would have been clearer separation between the Department’s hearing office and the rest of the Department and, thus, more apparent objectivity in reviewing assessments through the informal conference. The amendment also provided for a full 90 day period to file litigation following an informal conference, thereby eliminating the potential confusion that exists as a result of the current statute that begins the 90 days with the assessment itself and tolls the running of that period during the informal conference process.

Ultimately, the Department’s amendment was not introduced, the original bill was not adopted, and the current procedure for challenging assessments in Tennessee remains. It is likely, however, that this issue will be addressed again next legislative session.

C. Streamlined Sales Tax Deferred (Again!!)

The Tennessee General Assembly first adopted the Streamlined Sales and Use Tax provisions in 2003, with an initial effective date of July 1, 2004. The effective date has been delayed numerous times since those provisions were first adopted, with the General Assembly now delaying the effective date until July 1, 2015. It should be noted that, despite this delay in implementing the substantive provisions, the definitions applicable under the Streamlined Sales and Use Tax provisions became effective January 1, 2008, and those definitions themselves have substantive implications for Tennessee taxpayers.

D. Further Reduction of State Rate on Food

Public Chapter 323 continued Tennessee's efforts to reduce the tax impact on purchasing food. Under this legislation, effective July 1, 2013, the Tennessee state tax rate is reduced from 5.25 percent to 5 percent of the retail price of food and food ingredients for human consumption. This rate reduction does not apply to prepared food, dietary supplements, candy, alcoholic beverages and tobacco, all of which continue to be subject to the general state rate of 7 percent plus the applicable local rate. The applicable local rate also applies to food and food ingredients.
E. Final Return Filing: Indebtedness Provisions Enacted

Legislation has been enacted, for purposes of Tennessee franchise and excise taxes, that provides for the filing of tax returns while a taxpayer is on final return status and makes various revisions regarding tax returns and indebtedness of taxpayers. Specifically, any person or taxpayer who is starting a process that will result in the taxpayer ceasing to exist, or no longer being subject to excise tax, or no longer having any substantial remaining business or financial activity, such as merger, sale, or dissolution, is deemed to be in final return status, and such status applies to all subsequent returns filed by the taxpayer. The taxpayer must file a return for each tax period during which the taxpayer is in final return status, including returns of taxpayers with any remaining assets, activity, equity, or proceeds and of installment sales attributable to any state assets regardless of whether the entity has any remaining in-state activity.

In addition, if a person or taxpayer in final return status effects a complete liquidation that is initiated and completed on the same date, then the franchise tax is computed utilizing net worth, or the minimum franchise tax base, on the date immediately preceding the liquidating event. Otherwise, on any return of a taxpayer in final return status, the franchise tax is computed by using the average monthly value of net worth or the average monthly value of the real and tangible property owned in the state. If the taxpayer is part of an affiliated group that has elected to compute its net worth on a consolidated basis, such election would not apply to the taxpayer while it is in final return status unless the entire affiliated group is in final return status during the same tax period. Further, for any tax return of a person in final return status that covers less than 12 months, the franchise tax is prorated for the part of the year covered by the return. This last provision is a significant change from the current provisions regarding franchise tax.

Finally, the taxpayer must add to the net loss any amount excluded from federal gross income as a discharge of debt in title 11 bankruptcy when the taxpayer is insolvent or when the discharged debt is qualified farm debt. This provision applies to any tax year in which a discharge of debt occurred on or after October 1, 2013. H.B. 175, Laws 2013, effective May 13, 2013.

F. Property Taxes Provisions Amended

1. Green Energy Tax Base. Public Chapter 297, effective retroactively for the tax year 2013, revises the tax base for computing property taxes with respect to certain green energy production facilities. About a decade ago, electricity generating facilities using wind as the energy source were statutorily determined to have a tax base for property tax purposes that should not exceed one-third of the total installed facility costs; and, in subsequent years, legislation was enacted providing a "green energy production facility" with a tax base for property tax purposes that would not exceed one-half percent of the facility acquisition value. The term "green energy production facility" in this latter legislation included a facility certified by the Department of Environment and Conservation as producing electricity for use off the premises using geothermal, hydrogen, solar or wind sources. Opponents of the lower tax base authorized for green energy production facilities argued that this lower base violated the Tennessee Constitution. In fact, an opinion issued in late 2012 by the Tennessee Attorney General questioned the constitutional validity of that lower tax base. In order to resolve these
constitutional and other issues, Public Chapter 297 -- enacted in 2013 -- provides some analysis and reasoning for authorizing a lower tax base for certain green energy production sources, and determining that:

a. the value of wind source property should not initially exceed one-third of total install costs;

b. the value of solar source property should not initially exceed 12 and one-half percent of total install costs; and

c. the value of other green energy source property (presumably including geothermal and hydrogen) should not initially exceed its "appropriate capacity factor" as determined by the State Board of Equalization in consultation with the Department of Environment and Conservation. A certification from that Department is required in order to be eligible for this lower tax base.

2. Administrative Revisions. Public Chapter 209, effective April 23, 2013, made numerous technical and administrative revisions to the property tax laws in Tennessee. Just some of those revisions include:

a. the ability of the State Board to communicate certain decisions regarding property tax exemption applications via electronic means to the taxpayer;

b. providing the assessor of property with the express statutory authority to inspect or require the production of books and papers;

c. imposing upon the assessor the duty of confidentiality regarding information obtained from the property owner and providing for sanctions in the event such confidentiality is violated;

d. extending to back assessments, reassessments or corrections of assessment errors the existing statutory mandate that the validity of an assessment shall not be affected by any defect, error, irregularity or omission unless the foregoing shall result in a denial of minimum constitutional guarantees;

e. declaring that property maps prepared for property tax and assessment purposes shall not be conclusive evidence of property ownership in any court of law;

f. authorizing a county board of equalization to allow appearance before that board by telephone, television, software or other electronic means under certain circumstances; and

g. stating that equalization of commercial and industrial tangible personal property shall be directed using the appraisal ratios adopted by the board in each jurisdiction, but that no equalization factor may exceed a factor of one.
G. Hall Income Tax

1. Exemption for Seniors Increased. Public Chapter 322 continued the initiative from the 2012 Session by increasing the exemption for any person 65 years of age or older with respect to the Hall Income Tax imposed on dividends and interest. For tax years beginning January 1, 2013, this new law increases the total annual income exemption levels such that seniors who file an individual return and have total income of $33,000 or less (up from $26,200), or seniors filing a joint return having $59,000 or less (up from $37,000), are exempt from this tax.

2. Trustee Not Required to File Return. Public Chapter 480, effective May 20, 2013, amended the Hall income tax to provide that a trustee of a trust which is created under Sections 671 through 678 of the Internal Revenue Code (grantor trusts) as owned by one grantor or one other person which does not obtain a taxpayer identification number under federal law, shall not be required to file a Hall income tax return but shall report the total amount of income received by the trustee to the resident grantor or other person who shall file the return and pay this tax.

3. Confidentiality of Return InformationExtended. Legislation has been enacted that adds officers and employees of a district attorney general’s office or any state or local law enforcement agency to the list of public officers and employees required to maintain the confidentiality of tax information. Further, it is a Class E felony for such employees to disclose to any person, except as authorized by law, any such return or tax information. S.B. 405, Laws 2013, effective May 6, 2013.

H. Disclosure of Business Tax Credits to Local Officials Authorized.

The Tennessee Commissioner of Revenue is authorized, upon a written request, to disclose to a local government official the amount of a credit against Business Tax claimed by a taxpayer for personal property taxes paid. Disclosure is permitted solely for the purpose of allowing the local government to ascertain whether the taxpayer is paying the proper amount of local tax. S.B. 183, Laws 2013, effective April 29, 2013.

Notable Legislative Changes in Prior Years

A. Intangible Expense Legislation

As part of the Governor’s legislative package last year, Tennessee focused on closing the potential for tax planning allowed under the prior Tennessee franchise and excise tax statutes with regard to intangible expense payments made to affiliates. The General Assembly passed the Governor’s proposed legislation and, in so doing, adopted a number of related provisions that change in its entirety the process and basis on which taxpayers can deduct intangible expenses in the future. Under the prior statutes, which were adopted in 2004, taxpayers were entitled to take deductions for intangible expenses paid to affiliates by simply disclosing those expenses on a form provided by the Department and submitting that form as part of their franchise and excise
Tax returns. Under the prior statutes, the process for claiming the deduction is much more rigorous, and the ability to ultimately receive the deduction much less likely.

Taxpayers must now submit an application to the Department prior to filing their returns and can take an intangible expense deduction only if their application is approved by the Commissioner based on his or her determination that the expense disclosed in the application “did not have as its principal purpose the avoidance of the tax” levied by the franchise and excise tax statutes. Under the application that has been developed for this purpose and the nature of the inquiry required by the statute, it appears likely that many taxpayers previously taking an intangible expense deduction will not have their applications approved in the future.

Multiple applications have been pending with the Department since early 2013 with no response to-date so that the promised efficiency in dealing with these applications has not yet been met. Time will tell whether the delay is simply a result of the bureaucratic process or, rather, the Department questioning the applications as filed.

The statute, does, however, include three express circumstances under which the Commissioner is required to grant an application and allow an intangible expense deduction to be taken. First, under the “foreign affiliate exemption,” intangible expenses paid to affiliates in a foreign nation that is a signatory to a comprehensive income tax treaty with the U.S. are entitled to be deducted under the new statutes. Likewise, under the “conduit exemption,” expenses paid to an affiliate that, in the same year, paid the expense to an entity that is not an affiliate are also entitled to be deducted. Finally, with certain limitations expressly provided by the statute, the statute includes a “subject-to-tax exemption” that allows deductions of expense payments made to affiliates doing business in and subject to tax in a state that imposes a tax on net income. The Department has prepared a form that allows taxpayers to “check-the-box” and claim their entitlement to one of these deductions.

Under the new statutes, once an application is approved, the taxpayer can continue to take the approved deduction as long as the taxpayer certifies each year that there are no material changes in circumstances with regard to the expenses for which the deductions are taken. The Commissioner, however, has the discretionary authority to require taxpayers to submit a new application any time more than five years after an application was originally approved.

B. “Amazon” Sales Tax Exemptions Remain for One More Year

The Tennessee General Assembly approved a bill to temporarily exempt Amazon.com from collecting taxes on sales into the state and to follow through on the deal reached by the Governor and Amazon shortly after the Governor took office last year.

The bill, which does not mention Amazon by name, sets criteria for determining whether businesses with affiliates operating in Tennessee have sufficient nexus to require sales taxes collection. As a practical matter, it will require Amazon to begin collecting taxes no later than January 1, 2014, but leaves the company free not to do so until that date – unless Congress enacts federal sales tax streamlining legislation before that date requiring Internet retailers to collect sales taxes.
Former Gov. Phil Bredesen originally agreed – without enabling legislation – to refrain from pushing for Amazon to collect taxes when the company agreed in 2010 to open two fulfillment centers in Bradley and Hamilton counties in southeast Tennessee.

Governor Haslam, who took office in January 2011, followed up with a deal calling for new Amazon centers in Rutherford and Wilson counties in middle Tennessee in exchange for not requiring tax collections until 2014. Under the deal, the company will invest $350 million and create 3,500 new jobs in connection with its new facilities in exchange for not having to collect sales taxes until January 1, 2014.

The legislation gives effect to this deal by providing an express exemption from sales tax for out-of-state taxpayers with in-state fulfillment centers or similar facilities as long as those facilities are built between January 1, 2011 and January 1, 2014 and as long as the new facilities create at least 3,500 qualified jobs and involve a capital investment of at least $350,000.

According to the fiscal note associated with this legislation, the exemption will cost the state $22.8 million per year in lost revenue, but according to a legislative staff estimate, it will ultimately bring a similar amount into state coffers in the coming years.

C. Exclusion of Remote Members from Affiliated Group

Under legislation adopted last year, taxpayers electing to compute net worth on a consolidated basis for Tennessee franchise tax purposes are permitted to request in writing that the Commissioner exclude one or more persons qualifying as members where such persons are included within the affiliated group solely due to a direct or indirect interest and are so remote from the taxpayer that the taxpayer would be unable to determine combined net worth if such persons were included. A person may also be excluded where such person has a direct or indirect interest in both the taxpayer and one or more persons excluded for the reasons set forth above, and is otherwise so operationally remote from the taxpayer that the taxpayer would again be unable to determine combined net worth if such person was included. Requests must be submitted on or before the tax return due date for the period the taxpayer seeks for the exclusion to apply, although the Department may accept late requests where good and reasonable cause is established. Where a request for exclusion is granted, all members of the affiliated group are bound by such exclusion.

D. Elimination of Inheritance and Gift Tax

The Tennessee General Assembly also passed legislation to eliminate Tennessee’s inheritance tax (the so-called “Death Tax”) as well as its gift tax. The stated purpose of this sweeping legislation is to make Tennessee a more attractive state for economic growth and to prevent individuals who drive this growth from moving away from Tennessee to other states with more beneficial tax structures.

Tennessee Inheritance Tax. Tennessee currently imposes an inheritance tax on the estates of all persons residing in Tennessee and on the estates of non-residents who own property in Tennessee. Every estate has a $1 million exemption. Estates in excess of $1 million are taxed on a graduated basis, with the tax on the first $440,000 being $30,200 and any excess over
$1,440,000 being taxed at 9.5%. The legislation gradually repeals the inheritance tax over a four-year period with complete repeal for persons dying in 2016 and thereafter. Prior to 2016, the exemption will increase to $1.25 million for persons dying in 2013, $2 million for persons dying in 2014 and $5 million for persons dying in 2015.

Tennessee Gift Tax. In addition to being one of the minority of states with an inheritance tax, Tennessee had been one of only two states with a gift tax. Unlike the inheritance tax, there was no $1 million exemption. Accordingly, the Tennessee gift tax previously applied to gifts in excess of $13,000. The legislation completely repealed Tennessee’s gift tax for gifts made on or after January 1, 2012.

**RECENT JUDICIAL DECISIONS**

As is the case year-to-year, there were a number of important tax cases decided in the past years, as follows:

**Three Cases Define the Scope of Taxable Telecommunications**

Tennessee imposes a sales tax on the “furnishing, for a consideration, of intrastate, interstate or international telecommunication services.” Under the prior statutory definition of taxable telecommunications, telecommunications were defined as “communication by electric or electronic transmission of impulses.” Tenn. Code Ann. § 67-6-102(a)(32) (2003).

Tennessee courts construing this statute have applied the plain language of the statute and found that the scope of the tax on telecommunications services is limited to those services that have communication as their primary purpose. *See BellSouth Telecommunications, Inc. v. Johnson*, 2006 WL 3071250 (Tenn. Ct. App. 2006) (finding voicemail services taxable as telecommunications because the “true object” of those services was “to facilitate, albeit delayed, the transmission and receipt of telephone communication”). On the other hand, Tennessee appellate courts have consistently held that the tax on telecommunications services is not imposed on services that have information as their primary purpose. *See Equifax Check Services, Inc. v. Johnson*, 2000 WL 827963 (Tenn. Ct. App. 2000) (finding the check guarantee services at issue not taxable because “the true object of the transactions was not telecommunications services, but the information itself”); *Prodigy Services Corporation Inc. v. Johnson*, 125 S.W.3d (Tenn. Ct. App. 2003) (finding internet services not taxable); *Qualcomm Inc. v. Chumley*, 2007 WL 2827513 (Tenn. Ct. App. 2007) (finding the services at issue not taxable because the “ability to ascertain a vehicle’s location and load status is the primary reason” customers purchased that service).

Despite the apparent bright-line that has been drawn between taxable communication services and non-taxable information services, the Department has continued to test the boundaries of this distinction by imposing sales tax assessments on services that appear to be primarily devoted to providing access to information. As a result of those efforts, three different cases – *Level 3 Communications v. Roberts*, No. 05-2266-IV (Davidson County Ch. Ct. 2005), *IBM Corp. v. Farr*, No. 09-2144-I (Davidson County Ch. Ct., 2009), and *AOL, Inc. v. Roberts*, Nos. 05-2337-IV and 06-3097-IV (consolidated) (Davidson County Ch. Ct. 2009) – have been
presented to trial courts, appealed and have now been decided by the Court of Appeals and are
discussed below.

_Tennessee Court of App. Finds Data Connection Services Taxable as Telecommunications_

The Tennessee Court of Appeals issued its first decision in a line of three recently argued
cases that address the scope of Tennessee’s sales tax on telecommunications services. As
discussed below, despite upholding the tax at issue in AOL, Inc. v. Roberts, No. M2012-01937-
COA-R3-CV, the Court’s decision fails to give clear guidance to taxpayers about what services
are and are not taxable as “telecommunications.”

The Court described the services at issue in AOL as “port modem management” services
that Sprint Communications Company, L.P. (“Sprint”) sold to America Online, Inc. (“AOL”).
Those services connected AOL users to AOL’s data centers. AOL sought a refund of the sales
taxes it had previously paid with regard to these services, claiming the services constituted
“private line services” not taxable under Tennessee’s statutory definition of telecommunications
in effect during the relevant period. AOL also claimed the services were “enhanced services” and,
thus, not telecommunications services under the Court of Appeals’ decision in _Prodigy Servs. Corp. Inc. v. Johnson_, where the Court distinguished between the “basic” services
included in the statutory definition of telecommunications (e.g. telephone, telegraph, paging
services) and “enhanced” services (e.g. information services, conversion services, computer
services and Internet access) that the Tennessee General Assembly did not intend to come within
the statutory definition of taxable telecommunications. 125 S.W.3d 413 (Tenn. Ct. App. 2003).

Ruling on the parties’ cross motions for summary judgment, the trial court sided with the
Department and held that Sprint’s services did not constitute a “private line services” because the
services did not entitle AOL “to exclusive or priority use of a communication channel” within
the meaning of the statute. The basis for that conclusion was the court’s finding that, even
though AOL had “exclusivity over [the] portion of the transmission leg,” Sprint provided the
access number via the public switch network, which was not exclusively dedicated to AOL
traffic.

The Court of Appeals reached the same conclusion through a slightly different analysis.
The Court determined that the services provided by Sprint did not constitute a private line
service within the meaning of the statute because, rather than providing a “dedicated line
service” that connected two or more specific locations, Sprint provided additional services “that
enabled the receipt and preparation of the call for transmission.” In addition to transmitting calls
over lines dedicated to AOL, the Court pointed to the other components of Sprint’s service,
including the provision of access numbers, the management of calls received from members’
modems, and the preparation of data received at local access nodes for transmission. According
to the Court, “[t]he provision of these additional functions by Sprint took the entire service it
provided to AOL outside the statutory definition of private line service,” thereby making the
services subject to sales tax.

The Court also rejected AOL’s argument that the services constituted “enhanced
services” not subject to tax. Applying the “true object” test, the Court held that the true object of
Sprint’s services was telecommunications, as “AOL purchased the service in order to connect its members to its Data Centers.” The fact that Sprint provided additional functions such as the conversion of data, addition of IP addresses, and “a management function” “does not change the fact that the true object of the service was to transmit data from the AOL member to the AOL Data Centers.” Accordingly, the Court found that the sale of Sprint’s services was subject to sales tax as a telecommunications service.

**Tennessee Court of App. Finds Dial-up and Broadband Services provided to ISPs are not Taxable as Telecommunications Services**

On September 20, 2013, the Tennessee Court of Appeals issued its second decision regarding the scope of taxable telecommunications services. *Level 3 Communications, LLC. v. Roberts*, No. M2012-01085-COA-R3-CV. Level 3 provided dial-up and broadband Internet services to Internet Service Providers that, in turn, provided these services to end-users. The end-users connected to the system using a local telephone number. When the call reached Level 3’s infrastructure, Level 3 converted the call to Internet Protocol (IP) for transmission over the Internet. The call was then either terminated or transferred to the Internet. The broadband services were provided in essentially the same manner except that Level 3 was able to convert their data into IP using its own equipment. The trial court determined that the services provided by Level 3 did “not fall neatly into the definitions” as set forth in the statute. The trial court then applied the “true object” or “primary purpose” test that “Tennessee courts have used when a business activity is difficult to classify for tax purposes. The trial court concluded that the true object of Level 3’s activities was to provide Internet access on a wholesale basis through the use of telecommunication services and not to provide telecommunication services. The trial court also determined that the same outcome was controlled by *Prodigy Serv. Corp., Inc. v. Johnson*. That case distinguished between “basis services,” which satisfy the definition of telecommunication services, and “enhanced services” which do not satisfy the definition of telecommunication services. Basis services are those “involved [in] the offering of pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information,” whereas enhanced services combine basic services with “computer processing applications that act on the format, content, code, protocol or similar aspect of the subscriber’s transmitted information, or provide the subscriber additional, different or restructured information, or involve subscriber interaction with stored information.” The trial court then held that the services provided are enhanced services and the true object of transactions involving Level 3 is the provision of access to the Internet. Based upon *Prodigy Serv. Corp., Inc. v. Johnson*, the Court of Appeals affirmed the trial court.

**Tennessee Court of App. Finds Wide Area Network service are not Taxable as Telecommunications Services**

The third of these three cases, *IBM Corporation v. Farr*, No. M2012-01714-COA-R3-CV was decided by the Court of Appeals on September 24, 2013. In *IBM*, the Department of Revenue assessed sales and use tax on the sale of a wide area network service (WAN). The WAN was a technological infrastructure that linked the customers’ geographically separated computers in such a way that information stored on those computers could be accessed remotely. The physical infrastructure was comprised of routers, switches, data service units, dedicated
converters, circuits, transmission lines, and line monitors. The center of the WAN infrastructure was a data center where a mainframe computer was located. Each location was connected to the WAN. IBM’s customers connected to the WAN by using a telephone line and computer, and once connected, the customers could access information related to the customer’s business that was stored on geographically remote computers dedicated to the WAN. The trial court held that the WAN service constituted a telecommunication service because the information transmitted did not come from IBM but originated with the customer. Hence, the WAN was a telecommunications path that was taxable. The Court of Appeals reviewed its prior decisions regarding both “enhanced services” versus “basic services” as well as the “true object” cases. It concluded that IBM provided enhanced services and that the true object of the service was information and not telecommunications.

**Chancery Court Upholds Commissioner’s Variance Authority**

Following in the footsteps of the Tennessee Court of Appeals’ decision in *BAPCO*, a Tennessee Chancery Court has again upheld the Commissioner’s broad use of variance authority to require a taxpayer to apply an apportionment methodology other than the one required by statute. The taxpayers in *Vodafone Americas Holdings, Inc. v. Roberts*, No. 07-1860-IV (Davidson County Ch. Ct.) were partners in a national telecommunications business. For the years at issue in the litigation, the taxpayers mistakenly sourced sales of their telecommunications services to Tennessee if the customers of those services had a Tennessee billing address. Recognizing their error, the taxpayers sought a refund that would result from application of the statutorily-required cost of performance sourcing methodology. Rather than granting the refund, the Commissioner of Revenue chose to impose a variance requiring use of the market-based methodology to source sales, despite not identifying anything unusual or unique that would distinguish the taxpayers from any other telecommunications service provider or, indeed, the provider of any service across state lines.

Before the Chancery Court, the taxpayers argued that the variance constituted an abuse of the Commissioner’s discretion and should be declared of no force or effect. In support of this claim, the taxpayers argued that the variance imposed by the Commissioner was beyond the scope of his variance authority as limited by the controlling statutes because, rather than producing any incongruous results as required by those statutes, applying the standard statutory sourcing methodology to the taxpayers resulted in precisely the outcome the General Assembly intended when it adopted the costs of performance methodology for sales of services. Moreover, the taxpayers argued that, because there were no unusual circumstances to distinguish their provision of telecommunications services from other service providers, the variance violated the limits of the controlling regulation and, in actuality, represented the Commissioner’s improper attempt to usurp the legislature’s authority by adopting a new sourcing methodology for the telecommunications industry on an ad hoc basis.

The Chancery Court rejected the taxpayers’ arguments and found that the Commissioner had acted within his variance authority when imposing the variance at issue. Though the Court found the Tennessee Court of Appeals’ decision in *BAPCO* was not “on all fours” with the current case, the Chancellor nonetheless found *BAPCO* instructive and that, as in *BAPCO*, the Commissioner had the authority to impose the variance at issue. The Court placed special
emphasis on the reduction in tax liability that resulted from application of the statutory sourcing methodology. The taxpayers have appealed this decision to the Court of Appeals.

**Supreme Court of Tennessee Refuses to Review Court of Appeals’ Decision that Out-of-State Mail Order Book Seller is Subject to Tennessee Sales and Use Tax Collection Obligation**

In *Scholastic Book Clubs Inc. v. Farr*, the Tennessee Court of Appeals held that Scholastic, a Missouri-based bookseller with no real property, personal property, or employees located in Tennessee, had a sufficient presence in Tennessee to be subject to Tennessee’s obligation to collect sales and use tax on Tennessee sales.

The facts of the case were undisputed and showed that Scholastic is a Missouri corporation with no real property, personal property, or employees located in Tennessee. However, the company had significant sales in Tennessee, totaling approximately $34 million for the six-year audit period at issue.

Scholastic makes sales into Tennessee by mailing catalogs to classrooms in the state and to the homes of parents who home-school their children. The teachers or parents distribute the catalogs to the students, collect the students’ order forms and payments, and then return them to Scholastic, which delivers the ordered products by common carrier.

The Department of Revenue argued that that activity gave Scholastic a sufficient connection with Tennessee to allow the state to constitutionally impose its sales tax, and the Department imposed a nearly $6 million assessment, including penalties and interest, on the company.

Scholastic challenged the assessment, claiming the tax violated the Commerce and Due Process Clauses of the U.S. Constitution, as well as the Tennessee Constitution.

On appeal of the trial court’s decision in favor of Scholastic, the Court of Appeals reversed and found the tax to be constitutional. At the outset of its decision, the Court clarified that the only issue before it was whether the tax violated the Commerce Clause of the U.S. Constitution. The Court noted that the other two claims had not been adjudicated by the trial court and, thus, were not properly before the Court of Appeals.

Regarding the Commerce Clause issue, the Court said that the question was not, as Scholastic had framed it, whether the teachers in Tennessee acted as agents for Scholastic, but whether Scholastic’s activities – regardless of the agency status of the teachers – were sufficient to allow Tennessee to impose its sales tax.

The Court of Appeals said that there must be a “substantial nexus” between Scholastic and Tennessee before the state can impose its sales tax on the company. It explained that its decision was controlled by *Quill*, which provides that “an out-of-state vendor whose sales are by mail order must have some sort of presence in the taxing State for a sales and use tax to be permissible under the Commerce Clause.”
Although the Court identified that bright-line standard from *Quill* as controlling and recognized that courts in several other jurisdictions had already considered its application to Scholastic, it didn’t look to any of those decisions, writing instead that it found its prior decision in *Arco Building Systems Inc. v. Chumley* to be “instructive.” That decision held that the term “physical presence” in *Quill* was a “term of art” to describe the connections that had previously been found sufficient to support the imposition of state sales and use taxes on out-of-state companies. Accordingly, the Court found that rather than physical presence, the determinative Commerce Clause issue was “whether substantial business activities have been carried on in the taxing state on the taxpayer’s behalf.”

Using that standard, the Court held that Scholastic had sufficient activities in Tennessee to subject it to state sales taxes. The court found that the company didn’t qualify for the safe harbor *Quill* recognized for mail-order vendors because it was not a vendor whose only connection with customers in Tennessee was by common carrier or mail.

The Court wrote that Scholastic used Tennessee schools and teachers to facilitate its sales to Tennessee schoolchildren, and as a result had created “a de facto marketing and distribution mechanism within Tennessee’s schools.” The Court of Appeals found that sufficient to satisfy the substantial nexus requirement and *Quill’s* physical presence standard. Accordingly, it held the assessment to be permissible under the Commerce Clause.

Scholastic filed a petition with the Supreme Court of Tennessee, asking the Court to review the Court of Appeals’ decision. On June 22, 2012, the Supreme Court entered its order, declining review.

**On Remand from The Supreme Court, Trial Court Upholds Sale for Resale Exemption from Sales Tax of Aircraft and Affiliated Leasing Structures**

In *CAO Holdings, Inc. v. Trost*, the Commissioner challenged the application of the sale-for-resale exemption to a transaction involving brother-sister corporations owned by one individual. The transaction was challenged on three grounds. First, the Commissioner contended that the taxpayer violated the resale provision requiring the aircraft to be exclusively used for leasing. Second, the Commissioner contended that the lease by the taxpayer to the lessee was illusory. Third, the Commissioner contended that the resale transaction between taxpayer and the lessee should be disregarded as a sham.

The transaction in question involved the creation of two corporations by an individual. The first corporation purchased the aircraft and then leased it to the second corporation to operate the aircraft. The purpose of the first corporation was to insulate its individual owner from liability. The taxpayer purchased the aircraft under a certificate for resale. The purpose of the lessee was to arrange for time sharing agreements for the use of the aircraft. The lessee had one employee who was to pilot the aircraft, manage the aircraft’s maintenance and pay the company’s obligations. The lease agreement was a non-exclusive “dry lease” for a rental rate of $550 per hour. The flight logs listed the taxpayer as the “operator” of the aircraft, and the individual owner of the corporation was listed as a co-pilot on numerous flights. The trial court
granted taxpayer’s motion for summary judgment and the Commissioner appealed to the Court of Appeals, which upheld the ruling of the trial court.

The Commissioner was granted review by the Supreme Court which noted that, to qualify as a “sale for resale, the sale must meet two requirements:” (1) the purchase must be made for the purpose of resale, and (2) the sale must be “in strict compliance with rules and regulations promulgated by the commissioner.” When the resale is a lease, there is an additional requirement that the transaction must comply with the Commissioner’s rules and regulations which require that the property must be used “exclusively” for renting or leasing. The Commissioner contended that the taxpayer had used the aircraft for purposes other than leasing and did not qualify for the resale exemption because it had violated the exclusive use requirement of the regulations. (The Court noted that the use of the property by the lessor for purposes incidental to a lease such as maintenance and repair, cleaning, etc. did not violate the “exclusive use” rule.) In this situation, because the taxpayer/lessor was listed as the operator on all flights and because the individual owner of the taxpayer also used the aircraft, the Court held that the determination of exclusive use was unclear and could not be decided as a matter of law. Thus, the Supreme Court remanded the case for further consideration of this issue.

The Court also held that the Commissioner had failed to meet his burden of proof with respect to his other two contentions. The Supreme Court noted that, in order for a transaction to be illusory, it must constitute a “pretended transfer rather than a real transfer.” In this situation, the lease, on its face, constituted a real lease even though the terms were very favorable to the lessor.

Likewise, the Court held that the Commissioner had failed to meet his burden of proof that the transaction was a sham. The Court noted that when the Department of Revenue requests the courts to pierce the corporate veil in order to collect taxes, the courts’ review of the facts must be tempered by two principles. First, the courts should keep in mind that the “form and structure are quite significant in business and commercial transactions, and frequently the form or structure used has controlling significance for taxes and other purposes.” Second, the courts should heed Judge Learned Hand’s observation that there is no duty to increase one’s taxes.

On remand to the trial court, the trial court considered additional evidence regarding the taxpayer’s use of the aircraft and concluded that the taxpayer met its burden of proof in establishing that it used the aircraft exclusively for leasing purposes and met the requirements for the sale-for-resale exemption. The trial court further found that the Commissioner failed to prove that the lease was illusory and that the business lacked economic substance. Further, the trial court held that brother-sister corporations were “separate business entities with separate business purposes and independent values,” thereby rejecting the Commissioner’s argument that it was a sham transaction.
**In-State Supplier and In-State Seller of Soft Drinks Not Permitted to Allocate Tennessee Bottler’s Tax Liability**

In Dr. Pepper Pepsi-Cola Bottling Company of Dyersburg, LLC v. Farr, the taxpayer, Dr. Pepper Pepsi-Cola Bottling Company of Dyersburg, LLC (“Dr. Pepper”), manufactured, bottled and sold to distributors cases of bottled and canned soft drinks. Burks Beverage, LP (“Burks”) operated as a distributor of bottled and canned soft drinks during the period at issue. While Dr. Pepper and Burks are separate legal entities, they operate in the same building and have common ownership and common office and management staff. Dr. Pepper sold about 75% of its product to Burks and Burks purchased about 85% of its inventory from Dr. Pepper.

During the audit period July 1, 2004, through June 30, 2008, Dr. Pepper reported the major portion of its sales for purposes of Tennessee gross receipts tax on producers and sellers of soft drinks (“bottler’s tax”) on Burks’ tax returns, apparently to take advantage of Burks’ larger franchise and excise tax credit, which could be used to offset the tax. The Department of Revenue audited both Dr. Pepper and Burks, resulting in an assessment of tax and interest against Dr. Pepper in the amount of $155,804.10.

Dr. Pepper challenged the assessment, arguing that, because Tenn. Code Ann. § 67-4-402 permits out-of-state suppliers and in-state sellers to allocate the payment of the bottler’s tax between them, such right should be similarly afforded to in-state suppliers and in-state sellers. The Chancery Court ruled in the Department’s favor, finding no equal protection violation and further concluding that the plain language of the statute did not permit Dr. Pepper to use Burks’ franchise and excise tax credit.

The Court of Appeals affirmed the trial court. In so holding, the Court of Appeals – citing Kroger Co. v. Tollett, 608 S.W.2d 846 (Tenn. 1980) and Beaman Bottling Co. v. Huddleston, 1996 WL 417100 (Tenn. Ct. App, July 26, 1996) – concluded that the General Assembly’s intent behind the statute at issue was to first tax bottlers and, if the bottler is not “within reach,” then require the distributor to pay the tax based on the bottler’s gross receipts. Accordingly, the Court held that no express exemption existed for in-state distributors purchasing from in-state manufacturers.

Addressing the equal protection clause issue, the Court held that Dr. Pepper’s argument was properly analyzed under the “rational basis” test since it did not involve a suspect class, a quasi-suspect class or a fundamental right. Applying this standard, the Court ruled that the statute does not violate the equal protection clauses of either the United States’ or Tennessee’s Constitution.
Appellate Court Limits Tennessee’s Out-of-State Income Tax Credit on Dividends

In Boone v. Chumley, the Tennessee Court of Appeals held that Tennessee residents who own shares of a South Carolina S corporation are not entitled to a credit for taxes paid on dividend income. The Court held that the statute providing for an out-of-state income tax credit did not apply under the facts of the case because Tennessee and South Carolina do not have a tax credit reciprocity agreement, as required by the statute, and no such agreement could be implied.

Summary of Decision

During 2001, Turner and Sally Boone (“the Boones”) were residents of Tennessee and owned stock in two South Carolina corporations – Exchange Investment Corporation (“Exchange”) and RegisMilk Co. (“Regis”). For federal income tax purposes, Exchange and Regis elected to be treated as S corporations. The Boones, therefore, paid South Carolina income tax on their entire distributive share of the income of Exchange and Regis, including $204,988 that was distributed to them as dividends.

In Tennessee, the Boones filed a 2001 return for the Hall Income Tax – the limited individual income tax imposed on income from dividends in stocks and interests in bonds. When filing that return, the Boones claimed a credit for taxes paid to South Carolina. The Boones claimed the credit was proper under Tenn. Code Ann. § 67-2-122, which states that a Tennessee resident who is a shareholder of an out-of-state S corporation may deduct the tax paid to the other state “provided that there exists a tax credit reciprocity agreement between Tennessee and the other state.” Tenn. Code Ann. § 67-2-122. Notably, Tennessee does not have an express income tax reciprocity agreement with South Carolina.

The Tennessee Commissioner of Revenue rejected the credit taken by the Boones and issued an assessment for the additional tax owed, plus penalty and interest. The Boones paid the assessment and filed suit for refund, asserting two primary arguments in support of their refund claim. First, the Boones argued that a reciprocity agreement exists between Tennessee and South Carolina by virtue of the respective state statutes, each of which allows a credit for taxes paid to a sister state. In essence, the Boones argued that the court should imply a reciprocity agreement between South Carolina and Tennessee even though no express agreement exists. Second, the Boones argued that the Hall Income Tax, as applied by the Commissioner, violated the Commerce Clause of the United States Constitution because it taxes income that does not have a substantial nexus with Tennessee and is not fairly apportioned.

The Tennessee Court of Appeals ruled against the Boones on both of their arguments and upheld the assessment. The Court concluded that a reciprocity agreement could not be implied between South Carolina and Tennessee due to the fundamental differences in the states’ respective income tax schemes. The Court found that the Tennessee General Assembly did not intend to enact a reciprocity agreement with a sister state under which Tennessee could not receive a reciprocal benefit. Citing a Mississippi case, the Court stated that “the core ingredient of a reciprocity agreement between the taxing authorities of sister jurisdictions is an agreement by each jurisdiction to provide or forego certain benefits if the other jurisdiction will make similar concessions.” See Clement v. Stone, 15 So.2d 517, 522 (Miss. 1943).
Applying the foregoing rule to the facts presented in this case, the Court determined that a reciprocity agreement should not be implied because, if it were implied, there would be no reciprocal benefit to Tennessee. Unlike South Carolina -- which imposes a general income tax on an S corporation’s shareholders based on the corporation’s earnings regardless of the amount of dividend distributions – Tennessee imposes a limited income tax only on Tennessee residents and only on dividends or interest on bonds. Under these contrasting statutory schemes, if a South Carolina resident owned shares of a Tennessee S corporation, Tennessee would not tax the shareholder’s share of corporate earnings or dividends (because they were not paid to a Tennessee resident). Lacking any such reciprocal benefit, the Court refused to imply a reciprocity agreement that would effectively deprive revenue from the State of Tennessee.

The Court also refused to accept the Boones’ argument that the Hall Income Tax violated the Commerce Clause. The Court found that the S corporations’ distributions had a sufficient nexus with Tennessee because “it has long been accepted that income to a person from his or her intangible investments out the state, such as dividends from stock in a foreign corporation, constitutes income from within the state of the person’s residence.” The Court rejected the Boones’ attempt to characterize the dividend income as corporate income rather than personal income of the shareholders, stating that such a characterization was “based on semantics that are not sustainable.” To the extent the Hall Income Tax impacts interstate commerce as applied to the facts of this case, the Court found that the nexus of the Boones’ Tennessee residence was sufficient to support a tax that is apportioned according to dividends paid in Tennessee as opposed to total corporate earnings.

**Practitioner’s Comment**

For Tennessee residents who own shares of an out-of-state S corporation, this case raises a few important questions. First, which states have express tax credit reciprocity agreements with Tennessee? At least one authority suggests that the answer is actually none. See Robert Jamison et al., *Multistate Tax Guide to Pass-Through Entities* 45-3 (CCH 2007) (describing the credit provided in Tenn. Code Ann. § 67-2-122 and stating that “[a]pparently, there is no such agreement at this time”). There is very little case law on the topic, with the Court’s decision in *Boone v. Chumley* appearing to be the first reported decision addressing the Hall Income Tax credit for taxes paid to other states.

Assuming Tennessee has express reciprocity agreements with very few states, if any at all, the question then becomes whether an “implied” agreement exists with any other states. Again, the Court of Appeals’ decision in *Boone v. Chumley* suggests that the answer is likely no. At the very least, under the Court of Appeals’ decision, the applicable standard for proving an implied agreement exists will be difficult to meet because it hinges on whether the other state’s income tax framework is similar to Tennessee’s Hall Income Tax. Indeed, the Boones identified precisely this problem with the Court’s analysis in support of their refund claim, arguing that “if the pertinent Tennessee statute is not interpreted to allow reciprocity with states that have tax schemes different from Tennessee, the statute is rendered a nullity because all other states’ tax schemes are different from Tennessee.” Stating that it “proves too much,” the Court sidestepped this argument and, instead, emphasized that the focus must be on the facts presented in the case.
before it. Given the unique nature of Tennessee’s Hall Income Tax, however, the holding in Boone v. Chumley does suggest the Boones are correct. Under that decision, the out-of-state income tax credit set forth in Tenn. Code Ann. § 67-2-122 provides little to no actual benefit for shareholders of foreign S corporations.

**Court of Appeals Affirms Dismissal of Taxpayer’s Refund Claim Action Filed After Expiration of Statute of Limitations**

The taxpayer at issue in Swafford v. Comm’r of Revenue had paid a $21,212.82 unauthorized substance tax assessment in 2005. Subsequently, the Tennessee Supreme Court entered its decision in Waters v. Farr, 291 S.W.3d 873 (Tenn. 2009), ruling Tennessee’s unauthorized substance tax unconstitutional. Following that ruling, the taxpayer filed a refund claim with the Department of Revenue seeking the return of the $21,212.82 in tax he previously paid. The Department denied the refund claim asserting that it was filed beyond the applicable three-year limitations period for refund claims imposed under Tenn. Code Ann. § 67-1-1802.

The taxpayer filed suit in Davidson County Chancery Court asserting that, in light of the Supreme Court’s decision, the statute of limitation should be tolled to “provide him a meaningful opportunity to seek post-payment relief.” The Chancery Court granted the Department’s motion to dismiss on the grounds that the refund claim was untimely filed.

The Court of Appeals affirmed the Chancery Court, thus rejecting the taxpayer’s assertion that the dismissal of the claim violated his due process rights. In so ruling, the Court noted that Tennessee law provided adequate procedural safeguards by providing the taxpayer with the opportunity to file a refund claim within three years of December 31 of the year he paid the tax, which in this case expired on December 31, 2008, and further noted that proof in the record established that at least sixty other taxpayers had in fact submitted refund claims during the pendency of the Waters case.

**Chancery Court Prohibits Untimely Assessment**

In American Honda Motor Co., Inc. v. Farr, the Davidson County Chancery Court held that an assessment of franchise and excise taxes that had been imposed under unusual circumstances was untimely under the applicable statute of limitations. The facts that gave rise to this case were as follows. As part of its review of amended returns the taxpayer had filed in 2004, the Department determined the taxpayer had significantly overpaid its tax liability for 2000. Then, nearly four years later, and after crediting the taxpayer with that refund, the Department changed its mind and sought to reverse the credit through an assessment imposing $763,696 in additional taxes, allegedly for the year 2005. The taxpayer filed suit to challenge the assessment, arguing that it was barred by the three year statute of limitations because it actually imposed tax liability for tax year 2000. The Department contended the assessment was timely because it related to the year in which the taxpayer first applied the credit. Both sides filed cross-motions for summary judgment, and the Court agreed with the taxpayer that the assessment was, in actuality, a tax imposed for the year 2000 and, accordingly, untimely. The Department initially filed an appeal to challenge the trial court’s determination but subsequently withdrew the appeal. The trial court decision, therefore, is the final decision in this case.
In its decision in *Blue Bell Creameries, L.P. v. Roberts*, 2011 WL 198514 (Tenn. 2011), the Supreme Court of Tennessee reversed the court of appeals and found the capital gain at issue in that case properly subject to Tennessee’s excise tax. The taxpayer in *Blue Bell* was in the business of producing, selling and distributing ice cream in several states, including Tennessee. The taxpayer was created through a complicated business reorganization, the result of which, in pertinent part, was the taxpayer’s realization of a significant capital gain in exchange for the redemption of stock held in its parent company. The Tennessee Department of Revenue claimed the gain was subject to Tennessee’s excise tax on an apportioned basis and – after having that position rejected by the trial court and by the Tennessee Court of Appeals – the Supreme Court of Tennessee ultimately agreed.

The taxpayer raised two challenges to the tax on the gain resulting from the stock redemption. First, the taxpayer argued that the gain was properly classified as nonbusiness earnings under Tennessee’s excise tax statutes and, therefore, was not subject to tax in Tennessee. Second, the taxpayer argued that, even if the gain constituted business earnings, Tennessee was constitutionally prohibited from taxing the gain because it arose from the activities of its parent company, which were not unitary with the taxpayer’s activities in Tennessee. The Supreme Court of Tennessee rejected both of these arguments.

Looking at the business earnings issue, the Court reiterated that, in Tennessee, earnings qualify as business earnings if they satisfy either the transactional test or the functional test. The Court then found that the gain at issue did not satisfy the transactional test because it arose from a “one-time, extraordinary transaction,” not from “transactions or activity in the regular course of Taxpayer’s ice cream business.” With regard to the functional test, the Court noted that the determinative question is whether the acquisition, use, management, or disposition of the property giving rise to the earnings was an integral part of the taxpayer’s business. Recognizing that no Tennessee court had ever addressed the proper standard to apply under that test, the Court ultimately held that earnings from a taxpayer’s property satisfy the functional test if “the taxpayer’s control of the property contributes materially to [the] taxpayer’s production of business earnings.” Applying this standard to the gain at issue in *Blue Bell*, the Court found the taxpayer’s acquisition and sale of the stock that gave rise to that gain was a “necessary step in the reorganization of the business entities that profit from the production, sale, and distribution of Blue Bell ice cream” and also decreased expenses that had previously reduced earnings from the ice cream business. Accordingly, the Court found the sale and acquisition of the stock giving rise to the gain had “contributed materially” to the taxpayer’s ice cream business and, therefore, constituted business earnings subject to tax in Tennessee under the functional test.

Turning to the constitutional issue, the Court focused on whether the stock redemption and business reorganization that gave rise to the gain at issue were unitary with the taxpayer’s ice cream business. Applying what the Court referred to as the “operational-function” test to make that determination, the Court ultimately held that, because the stock redemption and business reorganization “served to increase net gain from the ice cream business,” it served an operational function, rather than an investment function, and was unitary with the taxpayer’s business in
Tennessee. In other words, the Court found Tennessee’s tax on the gain was constitutional for the same reasons it found the gain was business earnings.

Notably, the Court found that its unitary business analysis was limited to the operational-function test because the earnings at issue arose from the sale of assets, rather than the activities of separate business operations. Nevertheless, the Court went on to say that, even if its analysis were expanded to include a consideration of the relationship between the taxpayer and its parent company, the two entities were unitary because the parent company did not have any business operations of its own and both entities derived their income from the same, single ice cream business.

**Practitioner’s Comment**

The Supreme Court of Tennessee’s decision in *Blue Bell* overturned a sound decision in favor of the taxpayer. The appellate court’s decision had applied the unitary business principle to find no unitary relationship between the taxpayer and its parent company in a way that fairly construed the “hallmarks” of a unitary relationship as recognized by the United States Supreme Court: (1) centralization of management, (2) functional integration, and (3) economies of scale. The Supreme Court of Tennessee did not even consider these hallmarks and, instead, found a sufficient unitary relationship based on its determination that the gain at issue satisfied the “operational-function” test because the activity giving rise to that gain increased the revenue of the taxpayer’s ice cream business.

While *Blue Bell* was obviously a negative result for the taxpayer involved in that case, it does provide other Tennessee taxpayers with clarity for future cases involving the unitary business principle. Under *Blue Bell*, if earnings arise from an asset – as opposed to the operations of a business – the appropriate analysis is the operational function test. Under that test, if the asset “helps the taxpayer make better use of the taxpayer’s existing business-related resources,” it serves an operational function and is part of the taxpayer’s unitary business. On the other hand, if an asset serves to diversify a taxpayer and reduces its risks of being tied to one particular business, it serves an investment function and is not part of a taxpayer’s unitary business. Again, the application of this test in *Blue Bell* was contrary to the taxpayer, but clarity in the often murky area of the unitary business principle is at least somewhat of a benefit to future taxpayers.

The same can be said for the Court’s decision regarding the business earnings issue. The Court’s articulation of the functional test makes clear that earnings will only constitute business earnings under that test if the taxpayer’s control of the property that gave rise to the earnings “contributes materially” to the taxpayer’s earnings from its ordinary business operations. This test is a much narrower and more carefully defined standard for determining whether earnings constitute business earnings under the functional test than had been implied by the court of appeals in *Newell Window Furnishing, Inc. v. Johnson*, 311 S.W.3d 441 (Tenn. Ct. App. 2008). As with the Court’s articulation of the unitary business analysis, this clarity is, in many ways, a positive for taxpayers.
**Earnings from Passive Investment in a Related Entity Were Taxable**

In *H.J. Heinz Co. v. Chumley*, the Tennessee Court of Appeals determined that an out-of-state limited partnership (the taxpayer) had incorrectly listed its total earnings subject to Tennessee excise tax by improperly classifying approximately $117 million (disputed income) as non-business income when the income actually constituted business earnings.

The taxpayer contended that the disputed income was non-business income because it resulted from a passive investment in a related entity, and that it was not business income under the relevant Tennessee statute. The taxpayer also asserted that the Department of Revenue’s assessment of tax was in violation of the Commerce Clause of the U.S. Constitution. Finally, the taxpayer argued that, should the income be determined to be business income and the assessment of tax constitutional, the apportionment ratio used by the DOR was unfair and “drastically out of proportion.”

The court determined that the disputed income was business earnings under the functional test adopted by the Supreme Court of Tennessee in *Blue Bell Creameries, L.P. v. Roberts*. The disputed income in this case came from a related entity that apparently served no purpose other than to hold “stock in the parent Company and to pass dividend income to the taxpayer in the form of investment income.” The disputed income did not arise from a one-time extraordinary transaction, but from funds that flowed between the related entity and the taxpayer on a regular basis. Thus, the disputed income was properly characterized as business earnings.

A taxpayer challenging a tax assessment has the burden to demonstrate that it is unconstitutional. Here, there was no evidence in the record that the related entity concluded operations that were discrete from those of the taxpayer. Accordingly, under *Blue Bell*, the taxpayer did not carry its burden of demonstrating that the DOR’s assessment was unconstitutional.

The taxpayer also asserted that the state’s apportionment formula was unfair because it lacked factor representation. The court rejected this assertion and noted that the taxpayer relied on cases involving dividends from foreign affiliates. In the case at hand, the DOR was seeking to tax partnership investment income from the taxpayer’s investment in a related domestic entity, not income from foreign affiliates. The court found the taxpayer had failed to demonstrate, by clear and cogent evidence, that the DOR’s apportionment was grossly distorted or unfair.

**Tennessee Court of Appeals Holds Rented Motion Picture Films Are Tangible Personal Property for Franchise Tax Purposes**

In a lengthy opinion, the Tennessee Court of Appeals recently reversed a trial and held that rented motion picture films are tangible personal property and, thus, must be included in the minimum measure for Tennessee franchise tax purposes.

The Tennessee franchise tax is imposed at the rate of $.25 per $100 of the applicable tax base, which is the greater of (1) the taxpayer’s net worth computed in accordance with GAAP or (2) the book value of the taxpayer’s Tennessee tangible assets (unreduced by debt). To the
extent the tangible assets are leased, the minimum tax base is determined by a multiple of the rents (with different multiples used based on the nature of the tangible property).

In *Malco Theatres, Inc. v. Roberts*, Tenn. Ct. App. No. W 2010-00464-COA-R3-CV (April 26, 2011) the Court of Appeals held that the value of rented motion pictures must be included in the franchise tax base because they are tangible personal property. In doing so, the Court reversed the trial court’s decision that such “movies” and the “movie license fees” were not tangible personal property because they did not fall within one of the four categories of properties set forth in Tenn. Code Ann. § 67-4-2108(a)(3) (“real property,” machinery and equipment,” “furniture, office machinery and equipment” and “delivery or mobile equipment”).

In determining that motion picture films were tangible personal property, the Court of Appeals relied on law that had been developed under the State’s sales tax provisions, where the Court had previously determined that motion picture films were tangible personal property because the film had no value separate and apart from the tangible medium in which it was stored. As stated by the court, quoting from its prior decision, “[t]he film is inherently related to the movie, without the film there could be no movie.”

Further, the court held that the concept of “mobile equipment” included “any equipment that is capable of moving or being moved.” Given that the films could be moved from one film reel to another, the motion picture films easily satisfied this definitional category of taxable tangible personal property that would be valued, as with all rental property, based on a multiple of the rents.

Lastly, in what may, in fact, be the most interesting and significant aspect of the case, the Court held that a prior attorney general’s opinion from 1965 (an opinion that was requested by the Department) that supported the taxpayer’s position could, potentially, be binding precedent on the Department under Tenn. Code Ann. § 67-1-108 (precluding retroactive changes in policy). The Court remanded the case to determine, as a matter of fact, whether this attorney general opinion was Department “policy” and whether, if so, that policy had been changed retroactively through the Department’s action at issue in the case.

**Church Book Store, Fitness Center Not Exempt**

A book store/café area located in a church family life center facility was not exempt from Tennessee property taxes and only part of a family center/gymnasium also located in the facility was exempt because the book store/café area was used for retain purposes and part of the family center/gymnasium area was open to the general public on a membership fee basis. The book store had paid staff, inventory control, retain pricing, and a wide range of merchandise available for sale to general public and the space was not used in the traditional ways church facilities are used for fellowship, worship, and religious education. In addition, the fee-based gymnasium offered paid professional classes and was operated as a commercial entity. Further, the determination that the church did not use the areas for exclusively religious purposes did not impose a definition of “religious” in contravention of the First Amendment and did not excessively entangle the government with church doctrine and substitute the wisdom of the state for the doctrine of the church in contravention of the Establishment Clause. Imposition of
property tax on church property that is used in a commercial manner does not violate the doctrine, belief, faiths, or government of the church because operation of the retail book store and commercial fitness center was not necessary to accomplish the outreach ministry of the church. In addition, the church’s religious freedom and equal protection arguments were also rejected. Christ Church Pentecostal v. Tennessee State Board of Equalization, Tennessee Court of Appeals, No. M2012-00625-COA-R3-CV, March 21, 2013.

LETTER RULINGS AND ATTORNEY GENERAL OPINIONS
SALES & USE TAX

Tennessee Fails to Send a Clear Signal on Scope of Telecommunications Tax

For those taxpayers seeking clarity on the scope of taxable telecommunications in Tennessee, the Tennessee Department of Revenue has let you down yet again. In a recent revenue ruling, the Department demonstrated its continued struggle to apply the line between taxable telecommunications services and nontaxable information services. The cases that have interpreted and applied Tennessee’s prior statutory definition of telecommunications expressly recognized that when the “true object” of a service was to provide users with access to information, rather than the means to communicate, the service was not a taxable telecommunications service. See, e.g., Qualcomm Inc. v. Chumley, 2007 WL 2827513, *1, *8-9 (Tenn. Ct. App. 2007) (finding the service was not taxable telecommunications because “the true object of Qualcomm’s service was the provision of information rather than communication services”); Prodigy Servs. Corp. Inc. v. Johnson, 125 S.W.3d 413, 418 (Tenn. Ct. App. 2003) (noting the “Legislature intended to remove any possibility that information services could be taxed as telecommunications”); Equifax Check Servs., Inc. v. Johnson, 2000 WL 827963, *4 (Tenn. Ct. App. 2000) (upholding the trial court’s conclusion that the “true object of the transactions was not telecommunication services, but the information itself”); BellSouth Telecommunications, Inc. v. Johnson, 2006 WL 3071250, *3 (Tenn. Ct. App. 2006) (voice mail services were taxable telecommunications because “the true object of the voicemail services was to facilitate, albeit delayed, the transmission and receipt of telephone communication); Level 3 Communications, LLC v. Roberts, No. M2012-01085-COA-R3-CV, September 20, 2013 (providing dial-up and broadband Internet services to ISP’s were enhanced services and the true object was internet access); IBM Corporation v. Farr, No. M2012-0174-COA-R3-CV, September 24, 2013 (providing Wide Area Network services were not taxable because these were enhanced services and the true object was the information available on the WAN.)

The Tennessee General Assembly further solidified this distinction between taxable communication services and nontaxable information services through an amendment to the statutory definition of taxable telecommunications in 2004. Under that statutory definition, “data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by electronic transmission to a purchaser” are expressly excluded from telecommunications services. See Tenn. Code Ann. § 67-6-102(92)(B)(i). Both the controlling statute and the case law interpreting that statute, therefore, recognize a bright-line distinction between services that provide a means of communication, on the one hand, and those that provide access to information on the other.
The Department, however, has failed to recognize that distinction. In recent Revenue Ruling 12-25 (the “Ruling”), the Department determined that web-based services that facilitated online meetings or online training sessions were taxable “ancillary services” associated with, or incidental to, the provision of telecommunications services, despite the fact that those services were primarily aimed at providing access to information such as course materials, tests, and presentations. In doing so, the Department continued to blur the distinction between telecommunication and information services and added confusion to what could otherwise be a clear area of Tennessee law.

The Services at Issue

The taxpayer at issue in the Ruling (the “Taxpayer”) provided four different types of web-based services (the “Web Services”). All four of those services were provided by remote computer access. To access each of the services, the user was required to download an “applet,” or a piece of Java script needed to establish a secure internet connection to the Web Services.

The Taxpayer charged for the Web Services on a per-user subscription basis. There was no additional charge for downloading the applet, and the applet had no functionality except in connection with the Web Services.

With the exception of the applet, the Taxpayer did not sell, license, or transfer any software to its customers. Instead, the Taxpayer maintained its software on its own equipment, and such software and related equipment remained under the control of the Taxpayer at all times. The Taxpayer’s infrastructure used to provide the Web Services included multiple data centers, all of which were located outside of Tennessee.

Web Service #1 allowed the Taxpayer’s customers to provide remote technical support to their employees or to their own customers. Using the service, a customer’s technicians could gain remote access to an employee’s or customer’s computer to diagnose, troubleshoot, and resolve technical issues. The session was initiated through the applet, which allowed the user to access an Internet portal and begin the remote support session.

Web Service #2 deployed a technology similar to that of Web Service #1, except it allowed a subscriber to access his or her own computer remotely. After downloading the applet, a subscriber could use this service to access his or her own computer from any other computer connected to the internet through a private, secure connection. To do so, the subscriber visited the Web Services website, entered a username and password, and clicked the “connect” button for the desired host computer. A web-based broker or “traffic controller” located at the Taxpayer’s server site then authenticated and granted permission for the user to access the host computer.

Web Service #3 utilized a similar technological infrastructure to allow subscribers to conduct online meetings and online seminars (“webinars”) and securely present information online. The organizer of a meeting or webinar would invite participants by sending a URL, which enabled the participants to download the applet that supports the necessary connection to the Web Service. The participant viewed the online presentation from his or her own computer,
but the actual content, and the application used to display the content, remained on the organizer’s computer. In addition to presenting written materials, the organizer could use the service to initiate, save, and post recordings to a web server for viewing by participants.

Web Service #4 enabled subscribers to conduct online training sessions as well as online meetings like those available through Web Service #3. Capabilities associated with that training included the distribution of course materials, issuance of tests and assessments, publication of course catalogues, and maintenance of a reusable content library. The subscriber generated all of the content associated with the online training sessions. Such content was either uploaded to the Taxpayer’s server and maintained in the Taxpayer’s data centers or maintained elsewhere and distributed to participants through a URL.

The Department’s Ruling

The Department determined Web Services #1 and #2 were not subject to Tennessee sales and use tax but Web Services #3 and #4 were subject to Tennessee sales and use tax.

Focusing on the first two web services, the Department initially pointed out that the Taxpayer transferred tangible personal property in Tennessee when it provided the “applet” used to establish a secure connection to the Web Services. Because the applet was “a set of coded instructions designed to cause a computer . . . to perform a task,” the applet was “computer software.” See Tenn. Code Ann. § 67-6-102(20). Furthermore, the applet was “prewritten computer software” because it was a generic set of code not designed for any particular customer’s specifications. See id. § 67-6-102(70). The Department therefore concluded that the applet was tangible personal property for sales and use tax purposes. See id. § 67-6-102(91)(A).

Nevertheless, the Department concluded that this transfer of tangible personal property did not cause the transaction to be subject to sales and use tax because the applet was not the “true object” of the Web Services. The Department explained that customers purchased Web Service #1 “so that they can allow technical support agents to access their computer,” and they purchased Web Service #2 to “remotely access their home or office computer.” Without those services, the applet would be useless. Consequently, the applet itself was not the true object of the service, and the sale of that applet as part of the sale of services did not cause the transaction to be subject to sales and use tax as the sale of software.

The Department also determined that Web Services #1 and #2 did not constitute taxable “telecommunications services” or “ancillary services.” Under Tennessee law, a taxable “telecommunications service” is defined as “the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points.” Id. § 67-6-102(92)(A). According to the Department, Web Services #1 and #2 did not fit this definition because “all of the data involved . . . remains on the subscriber’s computer,” and the services “merely allow the subscriber or technical support agent to remotely view and manipulate the data at that single point, akin to attaching a second monitor to the subscriber’s hard drive.” The Department also noted that the “true object” of the services was to manipulate data at a single point on the subscriber’s hard drive, not convey data from the subscriber’s hard
drive to another point. As a result, Web Services #1 and #2 were not subject to tax as telecommunications services.

Likewise, the Department determined that Web Services #1 and #2 were not subject to sales and use tax as “ancillary services.” Ancillary services are statutorily defined as “services that are associated with, or incidental to, the provision of telecommunications services.” One particular form of ancillary service identified in the statute is a “conference bridging service” that “links two (2) or more participants of an audio or video conference call.” Id. § 67-6-102(7). The Department, nevertheless, concluded that Web Services #1 and #2 did not constitute ancillary services because the services’ provision of website functionality that enabled subscribers to access their home or office computers was not “incidental to . . . the provision of telecommunications services.” Id. Moreover, because the services did not involve any audio of video conference calling, they could not be considered “conference bridging services.” Id. § 67-6-102(7)(A).

The Department reached the opposite conclusion with regard to Web Services #3 and #4, finding those services were subject to Tennessee sales and use tax as ancillary services. With very little explanation, the Department emphasized that both the online training service and online meeting service used a combination of audio and visual communication to conduct online meetings, presentations, or training sessions. Accordingly, because these services “link two or more participants of an audio or video conference call,” the Department determined those services were “conference bridging services” that fell within the scope of “ancillary services.” Web Services #3 and #4, therefore, were subject to sales and use tax as ancillary services.

Practitioner’s Comment

While the Department appeared willing to apply the “true object” test at the outset of its Ruling, the Department disregarded this test in its evaluation of Web Services #3 and #4, inviting confusion into its ruling and the proper analysis of Tennessee law. Essentially, each of the services at issue in the Ruling allowed multiple users to view a single computer screen at the same time. When this technology was employed to allow the subscriber to access his or her own computer or to allow technical support staff to access a computer, the Department concluded that these services were not taxable as telecommunications because all of the data “remained on the subscriber’s computer” and the true object of the services was to “manipulate data at a single point, on the subscriber’s hard drive.” When those same technologies were used to facilitate online meetings – in which case, again, the content and the application used to display the content remained on one computer – these services were deemed taxable as “ancillary services” that are “associated with, or incidental to, the provision of telecommunications services.” The key distinction, according to the Department, was the audio and visual communication capability of Web Services #3 and #4. This distinction, in and of itself, led the Department to conclude these services were taxable “conference bridging services.”

Unlike its analysis of whether the transfer of the “applet” was itself taxable, the Department did not conduct even the slightest analysis of the “true object” of the two services it found taxable. Most notably, the Department did not consider the purpose of the service highlighted throughout the descriptive portion of the Ruling – that is, to facilitate the online
presentation and exchange of information. This purpose is underscored by features of Web Service #4 such as its reusable content library, distribution of course materials, publication of course catalogues, and issuance of tests and assessments. None of these capabilities “link participants of an audio or video conference call” – instead, they provide participants with access to information. In fact, it was for precisely this reason that the Department found Web Service #1 and #2 not to be taxable.

Rather than considering the various functions of Web Services #3 and #4 and analyzing the “true object” of the service, the Department, in a conclusory fashion, determined the service was a taxable ancillary service because it “linked participants of an audio or video conference call.” In contrast to relevant Tennessee cases that have applied the true object test and that have recognized the distinction between services that primarily provide communication and services that primarily provide access to information, the Department’s analysis failed to address or even acknowledge the informational purposes of the services. See, e.g., Qualcomm Inc., 2007 WL 2827513, at *1, *8-9 (finding the service at issue was not taxable because the true object of that service was “the provision of information rather than communication services”); see also Prodigy Servs. Corp. Inc., 125 S.W.3d at 418; Equifax Check Servs., Inc., 2000 WL 827963, at *4; BellSouth Telecommunications, Inc., 2006 WL 3071250, at *3; Level 3 Communications, LLC v. Roberts, No. M2012-01085-COA-R3-CV, September 20, 2013 (providing dial-up and broadband Internet services to ISP’s were enhanced services and the true object was internet access); IBM Corporation v. Farr, No. M2012-0174-COA-R3-CV, September 24, 2013 (providing Wide Area Network services were not taxable because these were enhanced services and the true object was the information available on the WAN.)

In the end, the Department’s oversimplified analysis of Web Services #3 and #4 suggests that if an online meeting or training service involves any type of audio or visual communication capability, the Department is likely to consider the service to be taxable as an “ancillary service,” regardless of the importance of that capability relative to other features of the service. That conclusion disregards the analysis required by the controlling statute and the case law interpreting that statute, under which the critical question is whether the “true object” of the service is communication or, instead, information. By avoiding this necessary analysis, the Department’s Ruling demonstrates its overarching desire to broaden the scope of taxable telecommunications and, unfortunately, adds confusion to this area of Tennessee tax law.

**Department seeks comments on taxation of compressor gas**

The Tennessee Department of Revenue has rescinded a notice that stated that sales and use tax applied to natural gas diverted from interstate pipelines extending through Tennessee and used to fuel in-state compressors. The department requests that interested parties provide comments by June 30, 2013 as to the appropriate application of sales and use tax statutes to these transactions. (*Important Notice No. 13-03)*

**Hotel room rental exemption discussed**

A Tennessee Department of Revenue letter ruling discusses the applicability of the sales and use tax exemption on hotel rooms occupied for 90 or more continuous days to room rentals
by a company under a contract with a hotel group (the taxpayer). Rooms rented by the company need not be occupied by the same employee to qualify for the exemption because the company, and not the employee, is the customer. The company’s employees do not need to occupy the same hotel rooms to establish continuous occupancy, but the rooms must be located in the same hotel. The taxpayer must establish that the company occupied a certain number of rooms at the hotel for 90 continuous days. If the number of hotel rooms occupied by the company fluctuates, the taxpayer must track the company’s occupancy rate at the hotel on a nightly basis. The night that the company occupies the fewest number of rooms at that particular hotel in any given 90-day period is the continuous occupancy rate for that period. There may be multiple 90-day periods being tracked simultaneously. Tax must be collected until the 90-day continuous occupancy requirement is met. Once the requirement is met, the taxpayer must first credit the company for tax collected and then apply for a refund or a credit. (Department of Revenue Letter Ruling 13-07)

**Applicability of Tennessee sales and use tax pollution control credit and Tennessee sales and use tax industrial machinery exemption to city landfill**

Taxpayer partners with municipalities to design, construct, and manage solid waste landfills in Tennessee. Municipality owns land, obtains zoning and permitting, and contracts with Taxpayer to construct, operate, and manage landfill for life of site. Taxpayer also provides waste collection and disposal services in Tennessee. Taxpayer, at various times, purchases materials and equipment to construct and/or operate solid waste disposal landfills. (1) None of materials or equipment purchased by Taxpayer to construct and/or operate solid waste disposal landfill qualify for pollution control credit found in TCA 67-6-346. Regardless of whether Taxpayer manages landfill that is privately owned or contracts with another party, such as municipality, to do so, Taxpayer is person/entity “primarily engaged in processing, treating, or controlling pollution created by others” and is, therefore, not entitled to claim credit under TCA 67-6-347. (2) Industrial machinery exemption applies to those materials and/or equipment purchased by Taxpayer to construct and/or operate solid waste disposal landfill that are used primarily for water pollution control, which is indicated by being required by U.S. Environmental Protection Agency’s rules and regulations promulgated under Clean Water Act. No other materials or equipment purchased by Taxpayer to construct and/or operate solid waste disposal landfill qualify as exempt industrial machinery. (Department of Revenue Letter Ruling 13-06)

**Application of Tennessee sales and use tax exemption under TCA 67-6-356 for telecommunications services used by call centers**

Taxpayer has a number of business lines that are conducted through various partnerships, limited liability companies, and corporations. Each business line is operated by separate legal entity that employs personnel required to conduct line of business, and each entity is registered for sales and use tax purposes. Taxpayer and its affiliates employ number of employees at company’s primary location, as well as in company’s other location. Certain Taxpayer associates located at company’s primary location utilize telecommunication services primarily in activities of providing customer service, soliciting sales, and collecting accounts receivable. Taxpayer and each affiliated entity are treated as separate entities for purposes of exemption
under TCA 67-6-356(a). As result, Taxpayer may not treat its employees and employees of its various affiliates as employees of single business for purposes of sales tax exemption.

TCA 67-6-356(a) exempts telecommunications services sold to “business for use in the operation of one (1) or more call centers.” TCA 67-6-102(9)(A). For this purpose, “business” is defined as “any activity engaged in by any person, or caused to be engaged in by such person, with the object of gain, benefit, or advantage, either direct or indirect.” “Person” is defined as “co-partnership, joint venture, association, corporation, ... or other group or combination acting as a unit, in the plural as well as the singular number.”

Taxpayer operates through number of related, yet different types of business entities. Due to different types of business entities employed by Taxpayer and its affiliates, only portion of the applicable definition of “person” potentially applicable to Taxpayer and its affiliates is if they are “group or combination acting as a unit.” Tennessee courts have not had occasion to expound proper interpretation of this statutory phrase, but some of Tennessee’s sister states have rejected claims that companies related solely by arm’s length contracts establish unit. Despite sharing common primary location, Taxpayer and its affiliates remain separate legal entities. Since separate entities are treated separately for tax purposes, Taxpayer’s affiliates are properly considered separate “persons,” and consequently, separate “businesses” for purposes of sales and use tax exemption. (Department of Revenue Letter Ruling 13-04)

**Online Advertising and Database Access Charges Not Taxable**

Charges by an online marketing company for website banner advertisements, advertisement of inventory on the taxpayer's websites, photography and set-up service charges, and access to online database applications and related application service provider (ASP) services are not subject to Tennessee sales and use tax because the transactions do not involve a transfer of tangible personal property or taxable services. Banner advertising and photography fees may include transfers of final artwork or advertising materials, but no furnishing of final artwork or advertising materials occurs in Tennessee. No taxable sale of tangible personal property occurs when the customer accesses the online database applications because the taxpayer does not transfer title, possession, or control of the applications to the customer, and the applications are not delivered or transferred to the customer or installed on the customer's computers. In addition, the provision of ASP services is not a taxable service. Because the customer's primary purpose of the transaction is the management and processing of its inventory data and information, the ASP services fall under the category of data processing and information services, which are specifically excluded from the definition of “telecommunications services.” (Department of Revenue Letter Ruling 13-03)

**Freezer Racks Qualify as Industrial Machinery**

Freezer racks used at a food production facility are exempt from Tennessee sales and use tax as industrial machinery. The freezer racks are equipment that is necessary to the taxpayers processing operation because they allow the taxpayer to freeze products in an efficient manner. The freezing of food products produced by the taxpayer, together with the maintenance of those products in a frozen condition, constitutes processing for purposes of the industrial machinery
exemption. The maintenance of the products in a frozen state, and thus the manufacturing process, continues until the products are removed from the racks. The freezer racks cannot be characterized as storage because at least 90% of their use occurs during the manufacturing process.  (Department of Revenue Letter Ruling 13-02)

**Taxability of Advertising Brochures Discussed**

When an advertising services company (the taxpayer) coordinates the printing of advertising brochures for customers using final proofs produced by the taxpayer, the brochures are advertising materials subject to Tennessee sales and use tax. Printing charges passed on to customers, and any charges by the taxpayer for the service of coordinating and managing the brochure printing process, are part of the sales price of the brochures. Final proof used to print brochures constitute final artwork. The sales price of final artwork includes costs directly allocable to the production of final artwork, excluding advertising services. The taxpayer cannot use a resale certificate to purchase artwork and images that are incorporated into final artwork. Services provided during the creation of the brochure mock-ups and preliminary proofs constitute advertising services. Such services are not, subject to tax at the time they are rendered, but they are included in the price of any advertising materials ultimately created and sold in the course of providing such services.  (Department of Revenue Letter Ruling 12-33)

**Advertising Materials Distributed Outside State Not Taxable**

Advertising materials printed outside Tennessee that are shipped to Tennessee for temporary storage at the taxpayer's distribution facility are not subject to Tennessee use tax if the materials are subsequently distributed outside Tennessee. Materials distributed in Tennessee are subject to use tax based on the entire cost of the transaction, including costs paid to design and develop the advertising materials, printing costs, transportation costs, and any other expense paid by the taxpayer to produce the materials, regardless of where the expenses were incurred. If the state where the advertising materials are printed imposes use tax on the materials, and the taxpayer actually pays the tax, the amount of tax paid to that state may be credited against Tennessee use tax due. (Department of Revenue Letter Ruling 12-31)

**Customer Loyalty Points Treated as Coupons**

For Tennessee sales and use tax purposes, loyalty points issued by a wireless telecommunications company (the taxpayer) to customers are considered in-store coupons. The sales price of a customer's monthly service fee is not reduced when points are issued to customers. When customers redeem points for a lower price on goods or services, the points function as an in-store coupon. The discount is excluded from the taxable sales price, and the sales price equals the net amount of cash and/or other consideration paid for the item or service. Use tax is not imposed on the taxpayer when points are exchanged for discounted property, unless the taxpayer fails to collect and remit the proper amount of sales tax. The redemption of points for nontaxable goods or services is not subject to tax, unless the nontaxable goods or services are bundled with taxable goods or services and sold for a single charge. (Department of Revenue Letter Ruling 12-30)
Taxability of Replacement Phones Discussed

A wireless telecommunications company (the taxpayer) is not required to collect Tennessee sales and use tax on phones provided to customers free of charge under the service contract portion of its replacement phone program.

Phones provided under the insurance policy portion of the phone replacement program are taxable. The service contract portion of the phone replacement program, which provides replacements to customers in the case of mechanical failures and specified types of damages, is properly characterized as a warranty contract because the taxpayer guarantees the quality of the phone by agreeing to replace it if it fails to perform correctly, the damaged phone is returned to the taxpayer for replacement, and no charge is made to the customer for the replacement of a damaged phone. Accordingly, the provision of replacement phones under the service contract of the replacement program are not subject to tax. The taxpayer's purchases of phones used in the phone replacement program are not subject to tax to the extent the phones are used to fulfill warranty obligations under the service contract portion of the phone replacement program.

The insurance portion of the phone replacement program provides replacement to customers whose phones are lost or stolen. If the insurance company approves a claim, the taxpayer will, upon direction from the insurance company, provide the customer with a replacement phone and invoice the insurance company for each such phone. The sale of a replacement phone by the taxpayer to the insurance company constitutes a retail sale when title to and possession of the phone are transferred to a customer in Tennessee on behalf of the insurance company. The sales price is the total amount paid by the insurance company to the taxpayer for the phone. The taxpayer's acquisition of such phones is exempt as a sale for resale. *(Department of Revenue Letter Ruling 12-29)*

Bone Regeneration Products Exempt as Prosthetic Devices

Surgical products used for providing a scaffold for natural occurring bone tissue regeneration and bone void filling to support bone remodeling are exempt from Tennessee sales and use tax as prosthetic devices. *(Department of Revenue Letter Ruling 12-28)*

Taxability of Items Used in Manufacturing Facility Expansion Discussed

The Tennessee Department of Revenue has issued a revenue ruling that discusses whether numerous items purchased by a manufacturer in connection with the expansion of a manufacturing facility qualify for the industrial machinery exemption from sales and use tax. In order to qualify for the exemption, the item must be machinery, apparatus, or equipment that is necessary to, and primarily for, the fabrication or processing of products sold by the taxpayer. Industrial machinery also includes parts attached to qualifying machinery, machines used to generate, produce, and distribute electricity, and pollution control facilities. Items that become part of a building, including all pilings, concrete, rebar accessories, and structural steel, generally do not qualify for the industrial machinery exemption. *(Department of Revenue Letter Ruling 12-24)*
**Application of sales and use tax prescription drug exemption to sale of in-vitro diagnostic reagents**

Taxpayer sells in-vitro diagnostic reagents (Diagnostic Reagents) to hospitals and other healthcare facilities in Tennessee. Diagnostic Reagents are licensed by United States Food and Drug Administration (FDA) and are used to identify certain properties of blood or blood components for purpose of determining compatibility in transfusions. For example, Diagnostic Reagents are used to identify blood groups, blood type, red cell antibodies, red cell antigens, platelet antibodies, and for crossmatching. Accurate testing of blood and blood components prior to transfusion is required by FDA in order to prevent potentially life-threatening reaction. Diagnostic Reagents do not require prescription, but may be used in test performed under orders of licensed physician. Diagnostic Reagents are not exempt from Tennessee sales and use tax under TCA 67-6-320(a), regardless of whether tests using reagents are performed under orders of licensed physician. Retail sales of Diagnostic Reagents are accordingly subject to Tennessee sales and use tax. Diagnostic Reagents are not for human use. Rather, they are used in laboratory test to identify certain properties of blood or blood components. While such use may occur in conjunction with treatment of human, reagents are not directly consumed, applied, ingested, or otherwise used by human. In addition, Diagnostic Reagents are not dispensed pursuant to prescription. (*Department of Revenue Letter Ruling 12-21*)

**Taxability of Software Maintenance Contracts Discussed**

A taxpayer located outside Tennessee is required to collect Tennessee sales tax on computer software maintenance contracts sold to customers in Tennessee. Taxability is determined by the location of the computer on which the software is installed. If the maintenance contract applies to software installed on a computer in Tennessee, tax applies, regardless of the location where the contract was made, and regardless of whether the taxpayer performs any repairs under the contract in or outside Tennessee. If the taxpayer fails to collect tax, the customer is subject to use tax on the contract. The taxpayer is not required to collect tax on charges for repair or replacement parts not covered by a software maintenance contract when the parts are sold outside Tennessee, but it is required to collect tax if the parts are shipped to a customer in Tennessee. Repair labor not covered by a maintenance contract is not subject to tax if it is performed outside Tennessee. If the taxpayer does not charge the customer for repair or replacement parts or repair labor under a maintenance contract upon which tax has been paid, the customer is not subject to use tax on the parts or labor. (*Department of Revenue Letter Ruling 12-20*)

**Application of Tennessee sales and use tax industrial machinery exemption set forth in TCA 67-6-206(a) to reusable specialty containers**

Taxpayer and its affiliates have manufacturing facility in Tennessee. Parts storage facility forms part of Taxpayer’s facility. Parts are transported by Taxpayer from parts storage facility to other parts of facility by conveyance dolly. Before placing parts on conveyance dolly, Taxpayer protects parts by placing them in reusable specialty containers. These containers protect parts from damage during transportation from storage at parts storage facility to production and assembly line. Each part is transported in container that has been specifically designed for that
part. Taxpayer’s reusable specialty containers used at project site qualify for industrial machinery exemption from Tennessee sales and use tax under TCA 67-6-206(a). TCA 67-6-102(46)(D)(ii) includes as part of definition of “industrial machinery” any equipment that is used for “transporting raw materials from storage to the manufacturing process.” Taxpayer utilizes parts storage facility for storing component parts. Most importantly, Taxpayer has indicated that at no time are reusable specialty containers used for storing raw materials or for moving raw materials around parts storage facility. Reusable specialty containers are clearly equipment that meets requirements of TCA 67-6-102(46)(D)(ii), and thus qualify as industrial machinery for Tennessee sales and use tax purposes. *(Department of Revenue Letter Ruling 12-16)*

**Application of Tennessee sales and use tax to natural gas sold to manufacturer for use in ovens**

Taxpayer produces food products for resale and uses natural gas in ovens at its Tennessee facilities. Ovens in question are direct-fired models, meaning that natural gas burners are located within oven chamber. Because gas burners are located within oven chamber itself, chemical energy created by burners comes into direct contact with in-process food products, completely enveloping oven chamber and any exposed portions of in-process products. All ovens used by Taxpayer share some common features — chemical energy created by natural gas burners is evenly distributed throughout oven chamber, and some portion of in-process product is always directly exposed to chemical energy created by natural gas. Additionally, there is no scenario in which food product going through one of ovens is completely shielded from chemical energy created by natural gas. Some of ovens are already separated metered (metered ovens) and can also install meters on such ovens. TCA 67-6-206(b)(1) imposes sales tax at rate of 1.5% with respect to retail sales of natural gas, when sold to or used by manufacturers. But TCA 67-6-206(b)(3) provides that retail sales of natural gas, electricity, fuel oil, coal, and other energy fuels will be entirely exempt from sales and use tax “whenever it may be established to the satisfaction of the commissioner, by separate metering or otherwise, that they are exclusively used directly in the manufacturing process, coming into direct contact with the article being fabricated or processed by the manufacturer, and being expended in the course of the contact.” Natural gas used in ovens comes within scope of exemption found under TCA 67-6-206(b)(3) to extent that it is used in metered ovens. But natural gas used in unmetered ovens is not exempt under TCA 67-6-206(b)(3). In any event, Department of Revenue Regulation 1320-5-1-.15(1) imposes number of requirements with respect to exemption under TCA 67-6-206(b)(3). Even if natural gas qualifies for exemption, TAXPAYER may not make tax-exempt purchases for particular location until it has applied for and received authorization to do so. *(Department of Revenue Letter Ruling 12-15)*

**Application of Tennessee sales and use tax to services relating to management of cooperative advertising funds**

Taxpayer has multiple clients who have entered into cooperative advertising arrangements with third parties. Pursuant to these arrangements, clients and third parties share certain promotional expenditures. Client provides cooperative advertising funds (Co-ops) that third party may utilize in its advertising. Co-ops are structured on reimbursement model,
whereby third party must submit claim for reimbursement from Co-op for promotional expenses that it has incurred. Taxpayer provides four types of Co-op services to clients — database management, information, administration, and reporting. Taxpayer provides no tangible personal property to clients in conjunction with Co-op services. Co-op services are not subject to Tennessee sales and use tax. No sale or transfer of tangible personal property occurs in conjunction with Taxpayer’s furnishing of Co-op services. Taxpayer does not sell, lease, license, or otherwise provide use of computer software to its clients in conjunction with these services. In addition, Co-op services do not constitute taxable services for Tennessee sales and use tax purposes. Moreover, no part of transaction can be described as furnishing of otherwise non-taxable service that is sold as part of sale of taxable good or service. Co-op services are provided on stand-alone basis, independent of any other goods or services that may be sold by Taxpayer. Taxpayer bills client for Co-op services separately and apart from any other goods or services that it may provide client. (Department of Revenue Letter Ruling 12-14)

**Exemptions Apply to Manufacturer's Purchases from Third Party Contractors**

Charges made by third party contractors to a manufacturer (the taxpayer) for the fabrication of tangible personal property, incidental to the process of manufacturing products by or at the direction of the taxpayer, are exempt from Tennessee sales and use tax as sales of industrial materials. The fabricated items are industrial materials because the taxpayer purchases the items for manufacture into articles of property, and the fabricated items become component parts of the taxpayer's finished products. Charges by third party contractors for the installation of tangible personal property and for reworking parts purchased by the taxpayer from parts suppliers, incidental to the process of manufacturing by or at the direction of the taxpayer are exempt as industrial supplies used in the manufacture of tangible personal property. Charges by third party contractors for repairing or cleaning items of tangible personal property during the process of manufacturing are exempt as sales for resale. Charges for repairing or cleaning items after completion of the manufacturing process of taxable. (Department of Revenue Letter Ruling 12-12)

**Application of Tennessee sales and use tax to dealer trade-ins**

Taxpayers (TP) are car dealerships that sell used and new motor vehicles in Tennessee. TP has customer that maintains fleet of vehicles, and periodically, this customer will trade in some of these vehicles and purchase replacement vehicles from TP. In single sales transaction in which customer purchases more than one vehicle from car dealer, sales price for Tennessee sales and use tax purposes is calculated by aggregating total price of all cars purchased from dealer in transaction and subtracting aggregate value of all trade-ins received from customer in single transaction. TCA 67-6-202(a) imposes sales tax on sales price of each article of tangible personal property sold at retail in Tennessee. TCA 67-6-510(a) allows for adjustment to sales price of item when purchaser trades in similar used item as part of transaction. TCA 67-6-510(a) and accompanying regulations do not specifically state that dealer may accept more than one used item as trade-in with respect to purchase of another item. But language of statute and regulations clearly contemplate that transaction may involve more than one trade-in item in single transaction. Accordingly, with respect to single sales transaction, TP may accept trade-in of more than one used vehicle with respect to purchase by its customer of one or more other vehicles.
Sales price of newly purchased vehicle or vehicles will be calculated by aggregating total price of all vehicles purchased from TP in that single transaction and subtracting aggregate value of all trade-ins received from customer in that same transaction. TP must document single sales transaction in manner that clearly identifies vehicles involved in that particular transaction. In instances in which TP is required by manufacturer or by law to retain separate documentation with respect to each vehicle involved in single trade-in transaction, TP may use, for example, master sales agreement identifying each vehicle involved. *(Department of Revenue Letter Ruling 12-06)*

**Whether retail sale of natural gas purchased outside of Tennessee and transported into Tennessee is subject to Tennessee natural gas distribution tax**

Taxpayer uses interstate pipelines that serve customers in Tennessee. Taxpayer does not own pipelines, rather, Taxpayer has contractual access to pipelines. Taxpayer purchases natural gas originating outside of Tennessee and transports that natural gas via interstate pipeline system to point in Tennessee designated by local distribution company (LDC) as “citygate” for deliveries, where natural gas is then delivered to Taxpayer’s customers served by that LDC. Taxpayer is unrelated to LDC. Taxpayer transfers to LDC equitable title to all gas delivered. Legal title in gas remains with Taxpayer until it is burned by end-user customer. Taxpayer receives meter readings from LDC and bills customer for gas used. LDC bills customer for local pipeline distribution fees. Taxpayer’s retail sale in Tennessee of natural gas is subject to 1.5% Tennessee gross receipts tax on gas distribution found under TCA 67-4-405(a)(2). Taxpayer exercises privilege of engaging in intrastate commerce carried on wholly within Tennessee, and not as part of interstate commerce. TCA 67-4-405(e) states that it is intention of law “to levy a tax for the privilege of engaging in intrastate commerce carried on wholly within this state and not a part of interstate commerce.” *(Department of Revenue Letter Ruling 12-03)*

**Applicability of Tennessee sales and use tax industrial machinery exemption in manufacturing facility**

Taxpayer has operated industrial facility in Tennessee. Facility, used for manufacturing, is shell that encompasses industrial machinery, equipment, appurtenances, and other items. In general, operations and activities at manufacturing plant consist of procurement of materials and transformation of those materials by industrial machinery and appurtenances into various products. Industrial machinery in this phase of production is located in “Phase A Manufacturing” area of manufacturing facility. Once products are produced, machinery and appurtenances transform products into other products, which are subsequently packaged for delivery. Industrial machinery in this phase of production is located in “Phase B Area” of manufacturing facility. (1) Taxpayer purchased items for expansion of its facility. Of various items purchased, only floor coating, exterior wall siding, safety showers, piping labels, fire stop, and lighting fixtures are not exempt from Tennessee sales and use tax. Remaining items purchased by Taxpayer — which include process tanks, freight elevator, electrical distribution equipment, special coatings, chillers, air receiver, filters, heat exchanges, pumps, standpipe, vacuum strainers, dust collection machinery, large and small diameter piping, communication monitoring equipment, demolition services, excavation and backfill services, heavy haul services, optical alignment services, and engineering services — are all exempt from Tennessee sales and use tax as industrial machinery.
(2) Contractor may not use Taxpayer’s industrial machinery authorization to make exempt purchases. But contractor may apply for its own industrial machinery exemption authorization number for Taxpayer’s project and may make exempt purchases with that authorization number. 

*(Department of Revenue Ruling 12-02)*

**Sales Tax Applies to Merchandise Redeemed by Point Program Participants**

The taxpayer engages in the business of providing access to incentive programs where participants can earn points which can be redeemed for various items of tangible merchandise from point program catalogs, which detail points needed for various items. The taxpayer tracks earned points in a database which participants can access to view their balances. However, points are not assigned a cash value and participants may not pay cash to purchase catalog items. The taxpayer bills its clients on a “per point” basis whereby charges are levied when points are awarded to a participant account attributable to the client. At the time clients are billed, it is not known whether points will later be redeemed or, if so, for what. The taxpayer also does not notify clients if, or when, participants make award selections. The taxpayer purchases catalog items in its own name from third party vendors and sometimes utilizes a resale certificate to do so. The taxpayer ships all catalog orders directly to participants from its warehouses located outside of Tennessee. Addressing the taxability of fees charged for points, the Department of Revenue opined that sales and use tax did not apply because such fee did not constitute consideration for the sale of tangible personal property, nor was it charged for a specifically enumerated service subject to Tennessee sales and use tax. With regard to catalog items shipped by taxpayer to Tennessee participants, however, the Department held that Tennessee sales and use tax applies because the merchandise transferred by the taxpayer to participants constitutes tangible personal property which was transferred in Tennessee in exchange for consideration. While the points serving as consideration have no stated cash value to participants, the Department concluded that the points nonetheless have value and further held that a value for such points could be determined by multiplying the per-point fee charged by the taxpayer to its clients by the number of points redeemed by a participant to purchase the merchandise. Such an approach in determining sales price is consistent with the definition of “sales price,” which is defined by Tenn. Code Ann. § 67-6-102 as the “total amount of consideration, including cash, credit, property, and services for which personal property or services are sold, leased or rented, valued in money, whether received in money or otherwise.” In the event that the taxpayer properly indicated to participants that point costs for merchandise includes sales tax, then the Department acknowledged that the sales price could be reduced to back-out the included tax.

*(Department of Revenue Letter Ruling 12-01)*

**Coins Sold as Precious Metals or Collectibles Are Taxable**

Tennessee may legally collect sales tax on transfers of gold and silver coins when the coins are exchanged for legal tender based on their intrinsic value as precious metals or as collectible items, rather than their value as legal tender. A tax on U.S. legal tender as legal tender would impinge on the power of Congress to establish a uniform legal tender, but Tennessee does not impose such a tax. Sales tax also applies to transfers of foreign coins when the coins are exchanged based on their intrinsic value as precious metals or as collectible items, rather than their value as legal tender. The General Agreement on Tariffs and Trade (GATD does not
prohibit the imposition of tax on such sales because the state does not impose tax on the importation of foreign coins. Rather, tax applies to sales of foreign coins after they have entered domestic commerce and are no longer characterized as imports. *(Attorney General Opinion No. 12-110)*

**Qualified Farmers and Nurserymen Not Entitled to Farm Equipment and Machinery Exemption for Purchase of Lawnmowers**

The taxpayer sells lawnmowers, including certain unnamed models having “a horsepower range of 22-37 hp and feature[ing] decks between 48 and 72 inches.” The taxpayer inquired whether sales of such lawnmowers to qualified farmers and nurserymen constituted exempt sales pursuant to Tenn. Code Ann. § 67-6-207(a)(1), which exempts “[a]ny appliance used directly and principally for the purpose of producing agricultural products, including nursery products, for sale and use or consumption off the premises, but excluding an automobile, truck, household appliances or property that becomes real property when erected or installed.” The Department held that the exemption did not apply to the lawnmower sales at issue because such mowers are “for use in groundskeeping, maintenance of transportation pathways, cutting brush to install fence lines, mowing, and similar activities.” The Department concluded that while such use may aid in the production of agricultural and nursery products, the mowers are “not used directly and principally for the purpose of producing the products.” *(Department of Revenue Letter Ruling 11-67)*

**LETTER RULINGS AND ATTORNEY GENERAL OPINIONS**

**FRANCHISE AND EXCISE TAX**

**Compromise Potential for Intangible Expenses Discussed**

The Tennessee Department of Revenue has issued a notice encouraging taxpayers taking intangible expense deductions in years ending on or before June 30, 2012, to request a compromise and settlement prior to September 30, 2013, for purposes of Tennessee excise tax liability. After September 30, 2013, the department will review such deductions taken, in years ending on or before June 30, 2012, on a case-by-case basis. However, the department will not continue to recommend compromises on the same terms if contacted by the taxpayer after September 30, 2013. *(Important Notice No. 13-06)*

**Whether compensation paid by Interest Charge Domestic International Sales Corporation, in form of dividend for federal tax purposes, is deductible from net earnings for Tennessee excise tax purposes**

Taxpayer is Tennessee corporation that is treated by IRS as Interest Charge Domestic International Sales Corporation (IC-DISC) for federal income tax purposes. Taxpayer’s two officers are each 50% shareholders of corporation. Each officer has compensation agreement with Taxpayer, whereby their compensation for services rendered is characterized for federal income tax purposes as dividend, as required by federal IC-DISC regulations. Amounts distributed as dividend to Taxpayer’s shareholders are not deductible from net earnings for Tennessee excise tax purposes. Internal Revenue Code does not provide deduction for dividends
paid to individual shareholders of IC-DISC, even if dividends are paid in lieu of salary. Thus, dividends paid by IC-DISC to its shareholders are not deductible as compensation and consequently, are included in federal taxable income. It follows that IC-DISC dividends paid to shareholders and included in federal taxable income are also included in “net earnings” for purposes of Tennessee franchise and excise tax. *(Department of Revenue Letter Ruling 13-08)*

**Intangible Expenses Addressed**

In this letter ruling, the Department discussed whether the discount charged on trade accounts receivable arising in the ordinary course of business from the sale of a company’s products constitutes an intangible expense in determining net earnings or loss for Tennessee excise and franchise tax purposes. In this instance, the discount charged on the accounts receivable is not considered an intangible expense under Tenn. Code Ann. § 67-4-2004(23). *(Department of Revenue Letter Ruling 12-32)*

**Licensing of Patents Does Not Give Rise to Nexus**

The Tennessee Department of Revenue has issued a letter ruling addressing whether the licensing of patents by an out-of-state company, the use of which gives rise to Tennessee sales by an affiliated licensee, causes the licensor to be subject to the Tennessee franchise and excise taxes. The out-of-state company was not subject to the Tennessee franchise and excise taxes under the facts presented, where the out-of-state company's contact with Tennessee arose solely from the eventual sale and delivery by the affiliated licensee into Tennessee of products manufactured outside of Tennessee, The licensor's contact with Tennessee was too remote and indirect so as to be characterized as an activity purposefully engaged in within the state with the object of gain, benefit, or advantage. Accordingly, the licensor was not doing business within Tennessee.

Perhaps even more interesting than the Ruling itself is a footnote included in the Ruling. In that footnote, the Department notes that “if Company A licensed its patents to an affiliate that used the patents in a manufacturing facility in Tennessee, Company A could be characterized as doing business in Tennessee” and cited the New Jersey case *Praxair Tech., Inc. v. Dir., Div. of Taxation*, 988 A.2d 92, 99 (N.J. 2009) for that proposition. As a result, it appears Tennessee is beginning to, at least, consider actively embracing an economic nexus theory for the franchise and excise tax. *(Department of Revenue Letter Ruling 12-27)*

**Whether limited liability company that is disregarded for federal income tax purposes to entity described in 1986 IRC 401(a), as amended, is considered not-for-profit entity for franchise and excise tax purposes**

Taxpayer is a trust and “governmental plan” within meaning of 1986 Internal Revenue Code (IRC) 414(d), as amended. Taxpayer is sole member of limited liability company (LLC). LLC is sole member of second limited liability company (LLC2). LLC2 is sole member of Taxpayer (TP). LLC, LLC2, and TP are all disregarded for federal income tax purposes. For Tennessee franchise and excise tax purposes, TP is not-for-profit entity. TP is, therefore, generally not subject to Tennessee franchise and excise taxation. But as not-for-profit entity, TP
is subject to Tennessee excise tax to extent its net earnings constitute unrelated business taxable income as defined in IRC 512, or are otherwise subject to income taxes under Subchapter A of Internal Revenue Code. Additionally, TP is subject to Tennessee excise tax on all net earnings that are attributable to any activities unrelated to and outside scope of activities that give it exempt status. Similarly, TP is subject to Tennessee franchise tax with respect to its Tennessee net worth, or real or tangible personal property owned or used, that is attributable to activities subject to income taxes under IRC 512 or any other provision of Subchapter A of Internal Revenue Code. Additionally, TP is subject to franchise tax on all of its Tennessee net worth, or real or tangible personal property owned or used, that is attributable to any activities that are unrelated to and outside scope of activities that gave TP its exempt status. (Department of Revenue Letter Ruling 12-26)

Availability of Tennessee job tax credit carryforward under TCA 67-4-2109

Taxpayer owns single member limited liability companies (LLCs) that are disregarded for Tennessee franchise and excise tax purposes. One of these disregarded entities (SMLLC) operates business in Tennessee. SMLLC filed business plan setting forth its anticipated capital investment and job creation in state. Job tax credit was generated, and portion of this credit was utilized on Taxpayer’s franchise and excise tax returns for two of Taxpayer’s tax years, leaving as remainder job tax credit carryforward. In third year, Taxpayer sold SMLLC to unrelated party. Taxpayer may utilize job tax credit carryforward on its Tennessee franchise and excise tax returns for tax years following sale of SMLLC to unrelated party. At time job tax credit carryforward was created, SMLLC was disregarded to Taxpayer for Tennessee franchise and excise tax purposes. Because SMLLC was treated as division of Taxpayer at time job tax credit carryforward was created, Taxpayer is considered to be entity that generated credit carryforward. In accordance with TCA 67-4-2109(e)(1), Taxpayer may therefore utilize job tax credit carryforward on its Tennessee franchise and excise tax returns for tax years following sale of SMLLC to unrelated party. (Department of Revenue Letter Ruling 12-17)

LETTER RULINGS AND ATTORNEY GENERAL OPINIONS
MISCELLANEOUS TAX

Proposed Property Tax Legislation Would Violate Tenn. Const. Art. II, Sec. 28

The Tennessee Constitution subjects “[a]ll property, real, personal or mixed” to taxation and provides that “[t]he ratio of assessment to value of property in each class or subclass shall be equal and uniform throughout the State, the value and definition of property in each class or subclass to be ascertained in such manner as the Legislature shall direct.” Only exceptions to this constitutional requirement of uniform taxation are contained in Tenn. Const. Art. II, Sec. 28, and are limited to property owned by state and local governments, property held and used for purely religious, charitable, scientific, literary, or educational purposes, and residential property owned by elderly and disabled Taxpayers. While General Assembly has significant discretion in creating tax incentives for businesses in Tennessee, General Assembly’s ability to do so in area of property taxes is greatly circumscribed by limiting language of Tenn. Const. Art. II, Sec. 28. Statute allowing for four-year period in which to phase in increase in assessment value on
commercial property resulting from capital improvements undertaken by business owner that substantially increase property’s value would violate Tenn. Const. Art. II, Sec. 28. Although proposed statute would appear to stimulate economic development, such goal cannot constitutionally be achieved by enacting legislation that effectively grants business owners partial property tax exemption for specified period of time to reward them for undertaking capital improvements to their property. Instead, Tennessee Constitution requires that such property be assessed in same manner as other business properties across state. (Attorney General Opinion No. 13-11)

**Itemization of Tax Permitted**

Tennessee licensees who sell alcoholic beverages for on-premises consumption are required to include alcoholic beverage and sales taxes in the prices shown on menus provided to customers. However, nothing in the applicable statutes or regulations prohibits licensees from separately itemizing taxes on receipts provided to customers. (Department of Revenue Letter Ruling 13-01)

**Whether Tennessee Business Tax applies to sales of automotive parts to party that assembles parts into products that are sold for resale**

Taxpayer supplies automotive parts to unrelated corporation in Tennessee (T-Co). T-Co assembles various parts, including parts from Taxpayer, at its facility in Tennessee. T-Co sells its parts to automobile manufacturers. In order to facilitate its sales of parts to T-Co, Taxpayer leases warehouse space in Tennessee to store automotive parts that T-Co has committed to purchase. Warehouse is operated by independent third party that is unrelated to Taxpayer. When T-Co requires parts, it sends its employees to Tennessee warehouse to obtain needed parts. After receiving parts from Tennessee warehouse, T-Co reports to Taxpayer which parts were obtained. Taxpayer then invoices T-Co for parts. T-Co has contractual duty to purchase excess automotive parts if there is significant change in its long-term order planning. This arrangement reflects intention of parties that all of parts shipped to Tennessee and temporarily stored at warehouse will be purchased by T-Co. Taxpayer’s receipts from sales of automotive parts to T-Co are subject to Tennessee Business Tax, at rate applicable to wholesalers under Classification 2. For Tennessee Business Tax purposes, businesses are classified under TCA 67-4-708 according to their dominant taxable business activity, and these statutory classifications determine rate and due date of tax. TCA 67-4-708(2)(A) includes under 27 “Classification 2” any business engaged in sale of “[n]ew or used motor vehicles, parts and accessories.” Assuming that Taxpayer’s dominant business activity in Tennessee is in fact sale of automotive parts, Taxpayer would come within Classification 2. Taxpayer’s sales are properly considered wholesale sales for Tennessee Business Tax purposes under TCA 67-4-702(a)(24)(B). In Taxpayer’s case, automotive parts are industrial material. Taxpayer sells automotive parts to T-Co for future processing, manufacture, or conversion into articles of tangible personal property for resale. Additionally, automotive parts become component part of finished product. (Department of Revenue Letter Ruling 12-23)
PRIOR YEAR LEGISLATIVE SUMMARIES

I. 2011 LEGISLATIVE SESSION.

The past year has seen a “sea-change” of sorts in Tennessee politically with the completion of Governor Bredesen’s run as Governor and, under that leadership, the service of Loren Chumley and Reagan Farr as Commissioners of Revenue. During that same time frame, we have seen the political winds shift from a democratically controlled legislature to one controlled, albeit by a thin margin, by republicans. Taking over Tennessee’s leadership are Governor Haslam and, at the Commissioner of Revenue post, Richard Roberts. Commissioner Roberts comes to the Department from corporate America, having served for many years as an executive and general counsel for a third-party logistics company, LandAir. While Commissioner Roberts brings his business experience, he admittedly had no substantive state and local tax knowledge at the time of taking his position as Commissioner. As a result, he has relied, for the most part, on the substantive knowledge of others, namely, Deputy Commissioners Glen Page and David Gerregano, and Head of Audit, Stacy Gibson to get up to speed and keep the business of the Department going during that process. At this point, it is too early to get a real sense of direction from the new administration, but the announced “policy” appears to focus on in-state companies over out-of-state companies, and that general theme was evidenced by the new administration’s first legislative session.

2011 LEGISLATIVE CHANGES

As with the previous administrations, the themes of “no new taxes” and expanding economic incentives continued to carry the day in legislative changes for 2011.

TAX INCENTIVES AND CREDITS

Job Tax Credit and Additional Job Tax Credits

Commissioners’ discretion modified. Tenn. Code Ann. § 67-4-2109(b)(3)(I) was revised to allow the Commissioners of Revenue and Economic and Community Development to lower the job thresholds for purposes of the additional annual job tax credit (i.e. the “super job tax credit”). Accordingly, the creation of as few as 50 new jobs (rather than the minimum of 100 jobs) may qualify for the super job tax credit. If the job threshold is reduced, the amount of the credit is also reduced proportionately. The amendment also eliminates the Commissioners’ discretion to lower wage and investment criteria and eliminates the requirement that the taxpayer be located in a central business district or economic recovery zone to be eligible for the reduced job thresholds.

First year in which job tax credits may be claimed. Under prior law, at least 25 jobs were required to be created within one year following the effective date of the business plan to claim the job tax credit. Tenn. Code Ann. § 67-4-2109(b) was amended to provide that at least 25 qualified jobs must be created within the investment period, rather than one year following the effective date of the business plan. The credit first applies in the tax year in which the taxpayer satisfies the capital investment and job creation requirements and in subsequent tax years within
the investment period in which there is a net increase in qualified jobs. The amendment also provides that the super job tax credit may be taken beginning in the year in which the taxpayer qualifies for the job tax credit, at the taxpayer’s election, but no later than the year following the end of the investment period. See Tenn. Code Ann. §§ 67-4-2109(b)(1)(C); 67-4-2109(b)(2)(C).

**Multiple job tax credits eliminated.** The new law clarifies that a taxpayer is not entitled to both the possibility of additional annual job tax credit for the tier 2 and tier 3 enhancement counties and the additional annual job tax credits for the capital investment and jobs creation thresholds. The enhancement county additional credits are 3 years for tier 2 counties and 5 years for tier 3 counties. The additional credits for the expenditure and job creation thresholds are 3 years for capital investments of at least $10,000,000 and up to 20 years for capital investments of $1 billion or more. See Tenn. Code Ann. § 67-4-2109(b)(2)(D).

**Headquarters Relocation Credit Extended to Existing Tennessee Headquarters**

Prior law provided a relocation credit to a taxpayer establishing a new headquarters facility in Tennessee. Public Chapter 508 amends Tenn. Code Ann. § 67-4-2109(h)(2) to allow the relocation credit for remodeled or expanded headquarters facilities already located in Tennessee. See Tenn. Code Ann. § 67-4-2109(h)(2), as amended by Public Chapter 508. The definitions applicable to the Headquarters Relocation Expense Credit, as set forth in Tenn. Code Ann. § 67-6-224, also were revised, as described below. Other changes to the Headquarters Relocation Expense Credit are as follows:

**Commissioners’ discretion to reduce job creation threshold.** Similar to the job tax credits referenced above, Public Chapter 508 amends Tenn. Code Ann. § 67-4-2109(h)(9) to allow the Commissioners of Revenue and Economic and Community Development to lower the job thresholds for purposes of the headquarters relocation credit with similar limitations. See Tenn. Code Ann. § 67-4-2109(h)(9).

**Period that facility must be used as headquarters modified.** The period for which the taxpayer must use the headquarters facility to avoid a recapture of the credit is measured from the end of the investment period rather than from substantial completion of the facility. See Tenn. Code Ann. § 67-4-2109(h)(5).

**Headquarters Sales Tax Credit**

Under prior law, the headquarters sales tax credit was available only in conjunction with the initial establishment of a headquarters facility. Tenn. Code Ann. § 67-6-224 was amended to make the credit available to remodeled and expanded facilities as well. The new law also makes changes to the job and investment criteria and further defines the expenditures that qualify for the credit by revising several of the definitions, including the definition of “qualified headquarters facility;” and “full-time employee job;” as well as limiting the Commissioner’s discretion to reduce the job creation threshold. The more significant changes include the following:
New definition of “qualified headquarters facility.” The new law revises the definition of a “qualified headquarters facility” in Tenn. Code Ann. § 67-6-224, which also applies to the relocation expense credit under Tenn. Code Ann. § 67-4-2109(h) to require a taxpayer to (i) make the required capital investment, and (ii) create the required number of jobs. The minimum capital investment is $10,000,000 and a minimum of 100 new full-time jobs must be created, in conjunction with the construction, expansion or remodeling of a headquarters facility. Under prior law, the taxpayer could meet the definition of a “qualified headquarters facility” by making a capital expenditure of at least $50,000,000 without the requirement that the taxpayer create a minimum number of jobs. Now, the jobs threshold must be satisfied regardless of the amount of the capital expenditure. See Tenn. Code Ann. § 67-6-224.

New definition of “full-time employee job.” The new law revises the definition of “full-time employee jobs” in Tenn. Code Ann. § 67-6-224(b) (2), which also applies to the relocation expense credit under Tenn. Code. Ann. § 67-4-2109(h) to provide that the jobs created must pay at least 150% of Tennessee’s average occupational wage to be counted toward the jobs thresholds in qualifying for the credit.

Commissioners’ discretion to reduce job-creation threshold. Similar to the headquarters relocation expense credit, the new law amends Tenn. Code Ann. § 67-6-224(e) to allow the Commissioners of Revenue and Economic and Community Development to lower the job thresholds for purposes of the headquarters relocation credit, with similar limitations.

To qualify for credit, jobs must be new jobs. Consistent with allowing the credit for expanded or remodeled facilities, the jobs threshold requires a net increase in employment above the level immediately preceding the beginning of the investment period (one year before the commencement of construction). See Tenn. Code Ann. § 67-6-224(b) (8).

New definition of “qualified tangible personal property.” The definition of qualified tangible personal property with respect to which the sales tax credit is allowed is further defined to be “property that is directly related to the creation of the new full-time employee jobs.” Presumably this would include any personal property necessary to construct, remodel or expand the headquarters facility and any furniture, fixtures and equipment used in the headquarters facility to perform headquarters functions. See Tenn. Code Ann. § 67-6-224(b)(11).

Credit and Net Operating Loss Carryforward Amendments

Previously, the 15-year carryforward limitation on the industrial machinery credit, job tax credits and net operating losses could be waived for taxpayers making a capital investment in excess of $1 billion (and in some instances investments of $100,000,000) if the Commissioners of Revenue and Economic and Community Development determined that allowing the additional carryforward was in the best interest of the state. The ability to waive that 15 year limitation has now been eliminated except for applications received and approved by the Commissioners on or before January 1, 2011. See Tenn. Code Ann. §§ 67-4-2006(c)(6) — (7); 67-4-2009(4)(C).
Effective Dates for Tax Incentives and Credits

The foregoing amendments are effective July 1, 2011; provided that those provisions apply to “any written proposal by the department of economic and community development or the department of revenue on or after [July 1, 2011].” Thus, the provisions allowing the commissioners to (i) extend the net operating loss carryforward provisions, (ii) extend the industrial machinery credit carryforward provision, and (iii) extend the carryforward provisions for the additional job tax credit if an application is made on or before January 1, 2011 do not apply to taxpayers to which the department of revenue or department of economic and community development made a written proposal before July 1, 2011.

OTHER TAX LEGISLATION

Gain on the Sale of Goodwill

Tenn. Code Ann. §§ 67-4-2012 and 2111 were amended to eliminate from the numerator and denominator of the receipts factor of the apportionment formula any gain on the sale of goodwill that is a Class VII asset as defined in the regulations promulgated under I.R.C. 338. The effect of the amendment is to exclude gain allocable to a sale of goodwill from the apportionment formula entirely, which for out-of-state companies could have been included in the denominator but wholly excluded from the Tennessee factor under the cost of performance test, assuming the services that created the goodwill were performed outside Tennessee.

Refund Periods May Be Extended

Under prior law, Tennessee’s refund statutes provided that a suit challenging the denial or deemed denial of a claim for refund must be filed within one year from the date the claim for refund was filed with the Commissioner of Revenue. The new law amends this provision and authorizes the Commissioner and the taxpayer to extend the one year period by agreement. See Tenn. Code Ann. § 67-1-1802(c).

Expedited Letter Rulings

A welcome amendment to taxpayers requesting letter rulings, the new law amends the letter ruling process to allow taxpayers the option of requesting expedited letter rulings from the Commissioner of Revenue. The fee for expedited rulings shall not exceed $10,000, and upon request, the Commissioner shall either issue the ruling within sixty (60) days from the date of the request or deny the expedited request and return the fee within seven (7) days after the request was submitted. The fee for all other letter ruling requests was increased from $200 to $500. See Tenn. Code Ann. 55 67-1-102(b)(9); 67-1-102(d)-(f).

“Shares Tax” Repealed

Effective January 1, 2011, Tenn. Code Ann. § 67-5-1101 et seq., known as the “shares tax,” which imposed a property tax on the intangible value of loan companies, investment companies, and cemeteries is repealed. The tax had been on the books since 1907 but, after the tax was
repealed as to banks in the 1970s, was not enforced uniformly, if at all. Beginning in 2008, certain counties began to assess the tax. The new law also amends the excise tax statutes to provide that a portion of the excise tax paid by financial institutions, including loan or trust companies, and a portion of the excise tax paid by regulated investment companies, is to be paid to the local governments in replacement of the “shares tax.”

**Interest Rate Unchanged**

By notice of the Department, the interest rate on all taxes collected or administered by the Tennessee Department of Revenue remains at 7.25%, effective July 1, 2013, through June 30, 2014. The interest rate for installment payments remains at 10.25%, effective July 1, 2013, through June 30, 2014.

**Food Rate Change Discussed**

The Tennessee Department of Revenue has issued a notice informing taxpayers that the state sales and use tax rate on food and food ingredients will decrease from 5.25% to 5%, effective July 1, 2013.

**Senior Exemption Increased**

Beginning January 1, 2013, the Tennessee Hall income tax exemption for taxpayers 65 years of age or older increases to $33,000 (formerly, $26,200) for single filers and to $59,000 (formerly, $37,000) for persons filing jointly.

**Warehouse Equipment Exemption**

Effective July 1, 2011, the sales and use tax exemption for material handling and racking systems used at a qualified warehouse or distribution facility was expanded to apply equipment used at a warehouse or distribution facility in the state that is purchased and either renovated or expanded through an investment in excess of $10 Million over a period not exceeding three years.

**Disaster Assistance Refund**

Effective June 16, 2011, individuals who receive disaster assistance from the Federal Emergency Management Agency (FEMA) as a result of a disaster that occurred in Tennessee between March 23 and May 12, 2011 are entitled to a refund of sales tax paid on eligible items purchased to replace or repair damaged items in the individual’s primary residence. Eligible items are major appliances and residential furniture with a sales price of $3,200 or less per item and residential building supplies with a sales price of $500 or less per item. The maximum refund per residence is $2,500. Eligible items must be purchased between March 23 and December 31, 2011. To claim a refund the claimant must file an application with the Department of Revenue by February 29, 2012. Only one application per residence is allowed.
Revised Captive Insurance Act Enacted

The Revised Tennessee Captive Insurance Act has been enacted thereby repealing and replacing the law concerning captive insurance companies. The law includes provisions that require each captive insurance company to pay to the Department of Commerce and Insurance, on or prior to March 1 of each year, a tax at the rate of 0.4 percent on the first $20 million, and 0.3 percent on each dollar thereafter on the direct premiums collected. The tax is calculated after deducting from the direct premiums subject to the tax the amounts paid to policyholders as return premiums which include dividends on unabsorbed premiums or premium deposits returned or credited to policyholders, except that no tax is due or payable as to considerations received for annuity contracts. In addition, each captive insurance company must pay to the Department of Commerce and Insurance, on or prior to March 1 of each year, a tax at the rate of 0.225 percent on the first $20 million of assumed reinsurance premium, and 0.15 percent on the next $20 million, and 0.05 percent on the next $20 million, and 0.025 percent of each dollar thereafter. The annual minimum aggregate premium tax to be paid by a captive insurance company is $5,000, and the annual maximum aggregate tax is $100,000.

Personal Property Tax Filing Requirements Amended

Tennessee law has amended the filing requirements applicable to tangible personal property schedules for property tax purposes.

Background. Under prior law, pursuant to Tennessee Code Annotated Section 67-5-903, each county assessor was required to furnish the Business Taxpayers in that county with a schedule by February 1 each year. The schedule as furnished by the assessor contains historical information regarding the valuation of the taxpayer’s tangible personal property in prior years. The taxpayer then lists all tangible personal property owned and used or held for use in the taxpayer’s business as of January 1 in that county including such other information as may be required by the assessor; places the correct valuation on the schedule for such property; and signs and returns the schedule to the assessor on or before March 1 of each year.

A taxpayer who fails, refuses or neglects to complete, sign and file the schedule with the assessor by March 1 is deemed by statute to waive objections to a forced assessment by the assessor. A forced assessment is based upon information that the assessor considers indicative of the fair market value of the property without necessarily considering the taxpayer’s information that otherwise would have been included on a timely filed schedule. Although a taxpayer has certain appeal rights from a forced assessment, those rights from a practical standpoint are not as effective as the rights of a taxpayer who has timely filed with the assessor.

New Law Eliminates Assessor’s Responsibility. Under the new law, the taxpayer continues to have the responsibility to complete and file the schedule with the assessor by March 1 of each year. However, consequences to the assessor for not providing the schedule have been eliminated by the following addition made to Section 67-5-903:
“Failure of the assessor to send a schedule or failure of the taxpayer to receive a schedule shall not relieve or excuse any taxpayer from filing such schedule by March 1 nor shall it prevent the assessor from issuing a forced assessment against the taxpayer.”

**Other Changes.** Under Section 67-5-903, business taxpayers have historically had the right to amend a timely filed personal property schedule at any time on or before September 1 following the tax year. Under the new law, business taxpayers continue to have the right to amend a timely filed schedule on or before that September 1, but the amendment may only be for the following reasons:

“... adding or deleting of property to correctly reflect the status of the property as of the assessment date; correcting the reported cost or vintage year of property; correcting the name or address of the taxpayer; deleting property that has been reported more than once resulting in a duplicate assessment; reporting property in the appropriate group; and correcting other reporting clerical errors.”

This new law further states that “...under no circumstances shall a taxpayer be permitted to amend a personal property schedule to submit an original claim for nonstandard value for property that was not the subject of a properly documented claim of nonstandard value in the timely filed personal property schedule.” Nonstandard valuations are important to business taxpayers that own or use in their operations certain equipment or other tangible personal property which depreciates faster than normal due to market conditions, obsolescence, or otherwise.

The business taxpayer now has essentially one month from February 1 to March 1 each year to complete and file this definitive schedule so as to protect the valuations considered appropriate - and that time frame assumes that the assessor even furnishes the schedule to the taxpayer on a timely basis by February 1.

**Miscellaneous Changes**

The new law also gives the Commissioner of Revenue the authority to require taxpayers to electronically file and pay Tennessee business taxes when tax liabilities equal $1,000 or more. Additionally, a $500 penalty, subject to waiver, may be assessed for any taxpayer who fails to follow the electronic filing requirements. The law also removes the limitation as to whom the Commissioner may delegate the responsibility of reviewing applications for waiver of penalty. Finally, any amount in excess of reasonable rent that is received or accrued for the rental, leasing, or comparable use of industrial and commercial property rented, leased, or otherwise provided to an affiliate is subtracted from the taxpayer’s net earnings, to the extent the corresponding expense has been added to the net earnings or net losses of the affiliate. This provision applies to tax years ending on or after June, 10, 2011.