# PUBLICATION

## Spotlight on Manufacturers: Tennessee's 2015 Tax and Related Legislation

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Manufacturing is a primary driver of our economic growth. As such, those businesses involved with fabricating, processing, converting and producing goods in today's marketplace must be ever-vigilant regarding new laws that could impact such growth, whether positively or negatively. New tax laws are no exception to such vigilance.

Tennessee's 2015 Legislative Session resulted in a large number of tax and related initiatives being enacted. Of particular note are certain tax provisions within both (i) 2015 Public Chapter No. 514 (the Administration's Revenue Modernization Act, herein "RMA") and (ii) 2015 Public Chapter 504 (a tax initiative from the Administration's Department of Economic & Community Development, herein "ECD Initiative"). Those tax provisions potentially relevant to manufacturers which are found within the RMA, the ECD Initiative as well as within certain other tax laws enacted in 2015 are summarized together with some brief comments.

**Sales/Use Taxes – R&D Recognized as Industrial Machinery**. Pursuant to Section 17 of the ECD Initiative, the industrial machinery exemption is expanded to include machinery, apparatus and equipment, with all associated parts, appurtenances, and accessories, and any necessary repair or taxable installation labor therefor, that is necessary to and primarily for "the purpose of research and development."

Comments: While this new exemption could be particularly beneficial to certain manufacturers, there are some open issues to address.

For instance:

- The term "research and development" is not defined in the ECD Initiative, and it is uncertain at present as to whether the Tennessee Department of Revenue (Department) will follow federal guidance or otherwise in regard to interpreting such term;
- It is also uncertain at present as to whether the Department will require an amendment to existing industrial machinery applications on file with the Department so as to include (where appropriate) research and development, or create a new form application solely for such equipment, or issue other guidance with respect to claiming this exemption for research and development; and
- Section 22 of the ECD Initiative states that such act "shall take effect July 1, 2015, the public welfare requiring it, and shall apply to tax years ending on or after July 1, 2015." This raises the question as to whether the exemption for research and development applies just to acquisitions after July 1, 2015, or would include earlier acquisitions which were still made during a tax year ending on or after July 1, 2015.

Pursuant to recent communiques with the Department, the Department may address some of the foregoing questions in the coming weeks.

**Sales/Use Taxes – Co-Generation Equipment Considered as Industrial Machinery**. Pursuant to 2015 Public Chapter No. 420, effective July 1, 2015, the industrial machinery exemption will include co-generation equipment that is purchased or leased by a qualified manufacturing facility and that is used for generating,

producing and distributing utility service directly to the qualified manufacturing facility. The term "qualified manufacturing facility" is defined to mean a facility that is located within a nonattainment area, as designated by the Environmental Protection Agency, in a county having a certain population and where the facility significantly reduces pollution particulate matter and where a capital investment has been made exceeding $30 million. This new provision is scheduled to sunset on December 31, 2016.

Comments: The county population requirements are not less than 48,500 nor more than 48,600 according to the 2010 federal census or any subsequent federal census – which appears to currently limit the exemption to those qualified manufacturing facilities within Loudon County, Tennessee.

**Sales/Use Taxes – Expanded Wastewater Treatment Equipment as Industrial Machinery**. The industrial machinery exemption currently includes equipment for use by county or municipality or a contractor pursuant to a contract for use in water pollution control or sewage systems. Pursuant to 2015 Public Chapter No. 81, effective July 1, 2015, language involving waste water treatment equipment is deleted and new language is substituted as follows: "or such use by a county, municipality or water and wastewater treatment authority created by private act or pursuant to the Water and Wastewater Treatment Authority Act, compiled in title 68, chapter 221, part 6, or a contractor pursuant to a contract with the county, municipality or water and wastewater treatment authority for use in water pollution control or sewage systems."

Comments: The Department reportedly considers most water/wastewater treatment facilities in Tennessee as being exempt. Nevertheless, the addition by this Act of water/wastewater treatment authorities, created either by private act or under the public Authority Act, may be of assistance in reducing costs incurred by those authorities in the construction or refurbishing of their treatment facilities – thus hopefully reducing costs for the private water users such as manufacturers.

**Sales/Use Taxes – Remotely Accessed Software**. Section 22 of the RMA provides that if a customer accesses software from a location in Tennessee as indicated by the residential street address or primary business address of the customer, such access shall be deemed equivalent to the sale or licensing of the software and electronic delivery of the software for use in this state, thus subjecting such use to taxation. The "use of computer software" is defined to include access and use of the software that remains in the possession of the dealer who provides the software or in possession of a third party on behalf of such dealer. Exemptions include numerous services that are not currently subject to the tax, such as the following among other services specified in Section 22:

- information or data processing,
- payment or transaction processing services,
- payroll processing services,
- billing and collecting services,
- internet access, and
- storage of computer software.

It also includes a new exemption created by Section 24 of the RMA for software accessed by a person for the exclusive purpose of fabricating other software that is both owned by and for that person's own use and consumption.

Comments: The Department issued Important Notice No. 15-14 in June 2015 providing guidance on the taxability of remotely accessed software. Manufacturing taxpayers should review their remotely accessed software services to confirm that the services utilized are within the listing of exempt services.

**Sales/Use Taxes – Streamlined Sales Tax Project Again Delayed**. The Streamlined Sales and Use Tax Project was delayed from the effective date of July 1, 2015, to July 1, 2017, by 2015 Public Chapter No. 273. The Project is a national effort to find solutions for complexities to simplify and modernize sales tax systems which are imposed by a significant number of states. Tennessee has been an associate member of the Streamlined Sales Tax Governing Board since its inception in 2005.

Comments: Since its inception, there have been concerns within Tennessee that this state should not become a full member of the Project. As a result, and even though legislation was enacted years ago so as to conform our sales and use tax laws with the Project, the effective date of many of those conforming statutes has been delayed on several occasions, the latest one now being to July 1, 2017. It is possible that the Department will again issue a Notice that the primary sales and use tax changes to become effective July 1, 2017, would include:

- requirements that sales delivered or shipped to the customer be sourced to the delivery or shipping destination;
- modifications to the single article limitation on local option sales taxes;
- use of a single sales and use tax return covering multiple dealer locations; and
- implementation of certain privilege taxes in lieu of sales taxes.

**Franchise and Excise Taxes – Triple-Weighted Receipts Apportionment Factor**. In an effort to assist with economic development, as well as to provide some fairness for large Tennessee employers that have substantial payroll and capital investments in Tennessee but sell their products predominately outside the state, Sections 8 (excise tax) and 16 (franchise tax) in the RMA increases the current double-weighting to triple-weighting for the receipts factor of the apportionment formula. This triple-weighting is effective for tax years beginning on or after July 1, 2016.

Comments: Efforts were made in the 2015 Session to enact a single receipts factor that could be used by large manufacturing employers with significant capital and payroll investment in Tennessee. The RMA's triple-weighted receipts apportionment factor, however, is applicable to all apportioning taxpayers and was as far as the Administration was willing to alter the current apportionment formula during this Session. Although counts may vary somewhat, of those 45 states plus D.C. having a business income tax it appears that:

- only one state currently has triple-weighting of the receipts factor;
- approximately 22 states have a single receipts factor in some form;
- approximately 14 states (including Tennessee at present) have a double-weighting of the receipts factor; and
- approximately nine states having the standard uniform weighting of the receipts factor.

The trend is clearly toward enhancing the weight of the receipts factor in the apportionment formula, if not using only that factor as the formula.

**Franchise and Excise Taxes – Job Tax Credit Made Permanent**. The current job tax credit for franchise and excise tax purposes defines a "qualified job" as being a job that meets various criteria, just one such criteria being that the job position is filled prior to January 1, 2016 – in essence, such date being the termination date of the job tax credit. One effect of Section 7 of the ECD Initiative is to eliminate that January 1, 2016, date, so as to make the job tax credit permanent.

Comments: This deadline elimination is a very positive step in the campaign to encourage existing or new employers (such as manufacturers) to expand or locate within Tennessee.

**Franchise and Excise Taxes – Integrated Customer/Supplier Eliminated**. Sections 2 (integrated customer) and 3 (integrated supplier) are eliminated as definitions for franchise and excise tax purposes. Section 8 of the ECD Initiative restates the enhanced job tax credit previously available to the integrated customer/supplier but without referencing those terms. These eliminations are effective July 1, 2015, and apply to tax years ending on or after that date.

Comments: The elimination of the enhanced job tax credits for integrated customers and integrated suppliers was justified by the Administration (through ECD) based upon the relatively low volume of taxpayers seeking or awarded such credits. For instance, ECD advised that there were only three integrated suppliers awarded this enhanced job tax credit during Tennessee's fiscal years ending June 30, 2012, through June 30, 2014. ECD also advised in the past that, because of the statutory restrictions on how the enhanced job tax credit may be used, some businesses otherwise qualifying as an integrated customer or supplier have decided to use the less restrictive standard job tax credit.

**Franchise and Excise Taxes – Other Eliminated Credits**. The ECD Initiative sunsets a number of other credits as of July 1, 2015, that were otherwise available for franchise and excise tax purposes, such expirations being justified because of the apparently low-volume usage of such credits and for other similar reasons. Some of these expiring credits include:

- the credit for qualifying environmental projects (Section 5); and
- certain certified green energy credits (Section 13).

Business plans submitted to the Department prior to July 1, 2015, may preserve the eligibility for some of these credits.

Comments: Similar to the rationale as to integrated customer/supplier credits, ECD justified the elimination of other credits based upon the low usage of those credits by taxpayers during Tennessee's fiscal years ending June 30, 2012, through June 30, 2014. In addition to the credits referenced in the preceding paragraph, other credits also eliminated as of July 1, 2015, include the following:

- the one percent industrial machinery credit for a general partnership that operates a call center (Section 4);
- the job tax credit for general partnership that operates a call center (Section 9);
- converting unused job tax credits and other credits into refundable credits by certain airline companies (Section 10);
- certain headquarters relocation credits (Section 11);
- certain headquarters credits tied to net operating losses (Section 12);
- certain qualified medical trade center relocations (Section 14);
- certain qualified advertising expenses promoting a qualified medical trade center (Section 15); and
- certain credits for buildings and other structures developed using the state funding method (Section 16).

Despite the initial versions of the ECD Initiative which would have eliminated the Brownfield tax credit based on similar low-usage reasoning, a last-minute amendment removed the Brownfield credit from the ECD Initiative – thus preserving that credit which can be particularly helpful to manufacturers.

**Franchise and Excise Taxes – Community Resurgence Job Tax Credit Act of 2015.** This new Act, found at 2015 Public Chapter No. 521, effective July 1, 2015, creates a job tax credit against the franchise and excise tax liability for certain qualified businesses. This new Act defines a qualified business as a new or existing business located in a high-poverty area according to the most recent decennial determination at the time that a

business plan is filed with the Department. The phrase "high-poverty area" means a census tract with a poverty level, in terms of total population, in excess of 30 percent according to the American community survey three-year estimates in 2013, and determined decennially thereafter as compiled by ECD in consultation with the Office of Local Government, Comptroller of the Treasury. The qualifying business shall create at least 10 qualifying jobs, and the credit shall first apply in the tax year in which the qualified business first satisfies the job creation requirements and in subsequent tax years in which further net increases occur above the level of employment established when the credit was last taken. The credit may apply to the franchise tax and to the excise tax; provided that the credit (together with any carry-forward) shall not exceed 50 percent of the combined tax liability shown on the return. Unused credit may be carried forward up to 15 years. The Department has the authority to conduct audits or require additional information to substantiate the credit. The aggregate amount of credits allowed to all taxpayers under this Act shall not exceed $12.5 million in any one tax year.

Comments: This new Act could be helpful to manufacturers that are looking to expand or locate in Tennessee and which would be receptive to such expansion/location being within a high-poverty area. According to the Act, the qualified business must file a business plan with the Department in order to qualify for the credit. The business plan must be filed in a manner prescribed by the Department and shall describe the type of business, the number of jobs to be created, the expected dates the jobs will be filled, and the effective date of the plan. It is uncertain at present as to whether the Department will issue a new form business plan for these purposes or simply modify the Department's existing job tax credit business plan to include the credit under this new Act. During the 2015 Session, the Department estimated that 40 new qualifying jobs would be created as a direct result of this new Act.

**Franchise and Excise Taxes – Certified Distribution Sales – New Apportionment Formula.** Section 14 of the RMA adopts a new elective apportionment provision for certain taxpayers having significant sales of tangible personal property in Tennessee which constitute "certified distribution sales." That phrase means the sale of tangible personal property "made in this state by the taxpayer to any distributor, whether or not affiliated with the taxpayer, that is resold for ultimate use or consumption outside this state; provided that the distributor has certified that such property has been resold for ultimate use or consumption outside this state." Assuming that the taxpayer makes an election under this new provision, "the total amount derived from certified distribution sales is excluded from the numerator of the taxpayer's receipts factor" – in essence, reducing the overall amount that is apportioned to Tennessee under the standard three-factor formula. In exchange for such exclusion, however, the taxpayer must pay a separate excise tax on the certified distribution sales equal to 0.5 percent if such sales do not exceed $2 billion; 0.375 percent of such sales that exceed $2 billion but not more than $3 billion plus a payment of $10 million; 0.25 percent of such sales that exceed $3 billion but not more than $4 billion plus an additional $13 3/4 million; and 0.125 percent of such sales that exceed $4 billion plus an added $16 1/4 million. This separate excise tax is in addition to all other taxes, including the existing excise tax. A taxpayer would be able to utilize this alternative, elective apportionment if its gross sales of tangible personal property in Tennessee exceed $1 billion and the taxpayer's receipts factor exceeds 10 percent. The effective date is January 1, 2016, and shall apply to all tax years beginning on or after that date.

Comments: This new apportionment formula is intended to encourage the location of distributors in Tennessee through the interaction of high-volume sellers (such as large manufacturers) of tangible personal property. A reasonable expectation would be that the Department would publish further guidance and forms for use in implementing this new apportionment formula.

**Franchise and Excise Taxes – Intangible Expenses Paid to an Affiliate**. For several years the Tennessee excise tax has prohibited (with certain safe-harbor exceptions) the deduction of intangible expenses paid by a Tennessee taxpayer to an out-of-state affiliate unless the Tennessee taxpayer applies to and is granted the right by the Department to take such deduction. For instance, a Tennessee manufacturer making royalty or

license fee payments to an out-of-state affiliate for use of patents or trademarks (among many other such circumstances) is required to submit such an application to the Department for approval to take a deduction for such payments. During the course of debating the RMA during the General Assembly, there was some inquiry as to whether this intangible expense application process would be needed following adoption of certain economic nexus provisions that are also part of the RMA. The RMA at Section 28, as enacted with a last-minute amendment found at Section 29, deletes the current application approval process for intangible expense deductions and substitutes the requirement that if such expense has been disclosed in accordance with Section 29, then such expense deduction is allowable if either of the following conditions are satisfied: (i) the affiliate to whom the expense has been paid is registered for and paying the excise tax to Tennessee; or (ii) the expense was paid to an affiliate in a foreign nation that is a signatory to a comprehensive income tax treaty with the United States or to an affiliate that is otherwise not required to be registered for or pay the excise tax. This new provision is effective July 1, 2016, and shall apply to all tax years beginning on or after that date.

Comments: Even though the application process was deleted as referenced above, the add-back requirement for "otherwise deductible intangible expense" under Tenn. Code Ann. Section 67-4-2006(b)(1)(K) as well as the special penalty provisions at Sections 67-4-2006(d) and 67-1-804(b)(2) for failing to comply with such add-back requirement, are still applicable.

**Conclusion**. Many of these new tax and related laws are very complex. Before acting upon or in regard to any of these new laws, careful consideration must be given to your particular fact situation.

Please contact any one of the attorneys within the Firm's Tax Group or the Firm's Manufacturing Initiative should you have any questions or otherwise wish to discuss any of these new Tennessee tax and related laws.