# PUBLICATION

## Spotlight on Tennessee: Factoring Transactions Are Not Subject to Related Party Intangible Expense Add-Back Statute

**February 12, 2013**

In 2012, Tennessee amended the excise tax statute to require prior approval before allowing intangible expenses to be deducted from net earnings for intangible expenses paid by one related party to another related party. In Letter Ruling #12-32, dated December 19, 2012, the Tennessee Department of Revenue (Department) has ruled that the discount or loss realized in a related party accounts receivable factoring transaction is not an "intangible expense" for purposes of determining the taxpayer's Tennessee net earnings or loss and, therefore, was not required to be added back to the taxpayer's net earnings.

**Factoring**

Factoring of trade accounts receivable is a financing transaction used by companies to manage their accounts receivable and to obtain financing. A "factor" is a specialized financial intermediary that purchases accounts receivable from a taxpayer (or client) at a discount. Pursuant to a factoring agreement, the price paid by the factor for the receivables is discounted from their face amount to take into account the likelihood of collectability or credit risk of the receivables. The payment by the factor for the receivables may be treated as a cash advance, and the factor typically charges interest on the advance plus a commission. In addition, in some cases, the taxpayer and factor may be engaged in a financing arrangement involving securitizing the receivables. Factoring may be on a recourse (taxpayer bears the risk of nonpayment) or nonrecourse basis (factor bears the risk of nonpayment).

**Letter Ruling #12-32**

In Letter Ruling #12-32, the taxpayer's business generated accounts receivable from the sale of goods or services. The receivables served as collateral for a line of credit at a favorable interest rate for the taxpayer. The taxpayer established a subsidiary corporation to hold that collateral. The subsidiary was located outside Tennessee and was initially capitalized with a contribution of accounts receivable from the taxpayer in exchange for stock of the subsidiary. To maintain the loan collateral, the subsidiary periodically replenished its receivables using factoring transactions with the taxpayer by using the cash received from the collection of receivables to purchase at a discount new receivables from the taxpayer. The amount of the discount was determined to be an amount that was at arm's length. As a result of the discount, the factoring of the receivables generated a deduction for the taxpayer.

As noted above, Tennessee is now one of approximately 21 states that have enacted related party intangible expense "add-back statutes." Like most of these states, Tennessee defines an "intangible expense" as "an expense related to, or in connection with, the acquisition, use, maintenance, management, ownership, sale, exchange, license, or any other disposition of intangible property, …" While the factoring transaction between the taxpayer and the subsidiary in Letter Ruling #12-32 generated a loss or expense item between related parties, the Department ruled that the pre-approval application requirements did not apply because accounts receivable do not fit within the add-back statute's definition of "intangible property."

**Summary**

Letter Ruling #12-32 sets Tennessee apart from a majority of the other states that have enacted similar related party intangible expense add-back statutes. Remember, however, that Tennessee law provides that Letter Rulings (unlike Revenue Rulings) from the Department are applicable only to the individual taxpayer and facts being addressed.

If you would like to discuss Letter Ruling #12-32 or other Tennessee state or local tax issues, please contact one of the attorneys in the Firm's Tax Department.