PUBLICATION

Spotlight on Tennessee: A Change of Seats on the Intangible Expense Add-Back Bandwagon

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The Tennessee General Assembly recently passed Senate Bill 2234/House Bill 2372, and Governor Haslam signed such legislation into law on April 27, 2012 (2012 Statute), changing how Tennessee will address deductions of intangible expenses paid to an affiliate for franchise and excise tax purposes. The issue of such intangible expense deductions has received intense audit scrutiny from the Tennessee Department of Revenue (Department) in recent years.

Background and History

Beginning with Ohio in 1991, states have sought to disallow income tax deductions of taxpayers who paid royalties or other intangible expenses, including interest, to related or affiliated parties. Those legislative efforts coincided with other states' assertions of economic presence nexus over intangible holding companies and financial institutions having only economic "connections" to a state. As a result, more than 20 years later approximately 20 states have enacted some form of intangible expense "add-back" legislation, while at least 14 states adhere to the economic presence nexus standard. Starting this year with its 2012 Statute, Tennessee becomes the 21st state to require a taxpayer to add-back deductions of intangible expenses paid to affiliated entities, taken for federal income tax purposes, when determining the taxpayer's net earnings for Franchise, Excise Tax purposes.

Since 2004, when determining Tennessee net earnings, Tennessee has required taxpayers to add-back intangible expenses paid to an affiliate that had been deducted from federal taxable income (the starting point for determining Tennessee net earnings). However, if the taxpayer disclosed the intangible expense payment on the face of the Franchise, Excise Tax Return, and completed Schedule J to such Return, then the intangible expense could be deducted. Obviously, the Department paid close attention to these disclosure forms and beginning in late 2009 issued "desk audit" assessments to a number of taxpayers who had disclosed and legitimately deducted intangible expense payments to affiliated entities. The Department's audit challenges sought a "variance" and denial of the deductions based on a variety of reasons, but primarily asserting that the intangible expenses were not at arm's length or were not supported by legitimate business purposes and economic substance. Some taxpayers challenged the assessments, while many entered into negotiations with the Department to construct a global settlement and compromise for 2005 and future tax periods -- culminating in the Department's issuance of Notice 11-17, dated November 2011. See *Spotlight on Tennessee: Settlement Opportunity for Previously Deducted Intangible Expenses (December 8, 2011)*

In conjunction with the Department's audit and settlement initiative, the Department also proposed legislation in the 2012 Legislature to amend Tennessee's intangible expense add-back or disclosure statute, but with its own unique twists that are a significant departure from other state intangible expense add-back statutes.

2012 Tennessee Intangible Expense Add-Back Legislation

The following outlines the major provisions of the 2012 Statute regarding intangible expense add-back:

A. "Intangible Expense": In general, "intangible expense" under the 2012 Statute means an expense related to, or in connection with, the acquisition, use, maintenance, management, ownership, sale, exchange, license, or any other disposition of intangible property (such as royalties, licensing fees, and the like). The term also includes interest expenses "to the extent such interest expenses are directly or indirectly for, related to, or in connection with the direct or indirect acquisition, maintenance, management, ownership, sale, exchange or disposition of intangible property." In other words, if the affiliate that is the recipient of intangible income makes a loan of that income to another affiliate, the resulting interest expense is included in the definition of "intangible expense." The inclusion of interest expense expands the prior Tennessee definition of "intangible expense." As a result, nondeductible related party interest expense is defined in a manner similar to that followed by other states, including Georgia, Kentucky, Massachusetts, and New Jersey, but not as broadly as defined by other states, such as Alabama and Indiana.

The legislation does not alter the definition of "affiliate" (generally, an entity that owns more than 50 percent of the taxpayer or that is owned more than 50 percent by the taxpayer).

B. Application: Tennessee's 2012 Statute allows a taxpayer to apply to the Commissioner of Revenue for permission to deduct affiliated intangible expenses if the expense "did not have as its principal purpose the avoidance of the tax levied by . . ." the excise tax statutes. The Department's review of the taxpayer's application shall include considerations outlined under the excise tax laws dealing with transactions between affiliates, such as (but not limited to) federal taxation concepts such as "assignment of income," "arm's length", and "fair market value" in dealings between and among affiliates.

The application is to be made at such time and upon such forms and in such manner as the Department shall prescribe. Those forms are in the process of being prepared by the Department.

In addition, if the taxpayer satisfies one or more of three exceptions, then the Commissioner is required to approve the application. Alternatively, a taxpayer may rely on the notice or conference procedures (described below) in lieu of an application.

C. Exceptions: The 2012 Statute provides three exceptions. If any of the exceptions apply, then the taxpayer shall be entitled to provide notice to the Commissioner at the time of filing its Return, rather than making application, that an intangible expense is deductible. If the taxpayer chooses to file an application on the basis that one or more of the exceptions applies, the Commissioner shall approve the application. The exceptions are as follows:

1. **Tax treaty exception:** If the affiliate who receives the intangible expense is "in a foreign nation that is a signatory to a comprehensive income tax treaty with the United States," then the intangible expense is deductible, and the taxpayer's application shall be approved.
2. **Conduit exception:** If the intangible expense is paid to an affiliate that, in the same taxable year, pays the intangible expense to an entity that is not an affiliate, then the taxpayer's application to deduct all or a portion of the intangible expense shall be approved.
3. **Subject to tax exception:** If the affiliate is subject to a net income tax in another state, not including a state that includes the taxpayer and affiliate in a combined or consolidated return in which the affiliate's intangible income is offset by the taxpayer's intangible expense, then the taxpayer's deduction for the amount of intangible expense apportioned or allocated by the affiliate to that taxing state shall be approved.

D. Application, Notice or Conference? As noted, a taxpayer may (i) apply for permission to deduct intangible expenses; (ii) the taxpayer may simply give notice when it files its Franchise, Excise Tax Return that it is relying on one or more of the exceptions to add-back and an application is not necessary; or (iii) the

taxpayer may request a conference with the Commissioner to review its facts and circumstances and seek a letter that its intangible expenses are deductible and an application is not necessary. A taxpayer's decision on which procedure to pursue will likely be driven by a taxpayer's desire for definitive treatment and penalty protection (application or conference) versus expediency and tolerance for audit risk and potential penalties (notice based on taxpayer's assertion that an exception applies). It is unclear how other factors will enter into a taxpayer's decision (e.g., FIN 48).

If a taxpayer opts for the application and it is approved, the approval is effective for "so long as the taxpayer submits annually to the Commissioner a certification that the facts and circumstances remain substantially unchanged." However, the Commissioner may require a taxpayer to re-apply "no sooner than five (5) years following the taxpayer's most recent application."

E. Denial of the Application: If the Commissioner denies a taxpayer's application, the taxpayer under the 2012 Statute may still claim the deduction subject to assessment of tax, penalty and interest by the Department. In that event, the taxpayer is granted the right to pursue its administrative remedies. It appears that a denial of a taxpayer's application is not grounds to pursue an administrative appeal such as might be the situation where the taxpayer is denied a certificate. To challenge the denial for intangible expenses paid to an affiliate, it appears that a taxpayer must claim the deduction, be assessed, and then commence the pursuit of those remedies applicable for contesting a Tennessee state tax.

F. Penalties: A failure to add back intangible expenses, whether or not a taxpayer applied for permission, is subject to a negligence penalty equal to the greater of $10,000 or 50 percent of the resulting tax adjustment. (There had been some discussion with Department that if a taxpayer applied for permission to deduct intangible expenses and such application was denied, but the taxpayer nevertheless added those expenses back to Tennessee net earnings on its Return and also on that Return deducted those same expenses, then the Department would not impose a penalty since the taxpayer would have complied with the requirement to submit an application and would have complied with the requirement to add-back the intangible expenses, even though such expenses were also deducted on the Return -- however, that concept did not become part of the 2012 Statute.)

If an application under the 2012 Statute is submitted at least 60 days prior to the due date of the taxpayer's Franchise, Excise Tax Return and the application has not been approved or denied by the due date for the Return, then no penalty is assessable in the event the taxpayer's intangible expense deduction is later disallowed (and interest does not accrue from the due date of the Return to the date the Commissioner issues a denial of the application.)

G. Effective Date: Under the 2012 Statute, the new intangible expense add-back statutory provisions apply to all tax years ending on or after July 1, 2012.

Conclusion

Tennessee's 2012 Statute addressing the new intangible expense add-back requirements is a significant change in the State's treatment of related party transactions for franchise and excise tax purposes. Although Tennessee now joins 18 other states in restricting or disallowing deductions for affiliated intangible expenses, taxpayers do gain some measure of certainty (vs. the Department's audit selection process) and some clarity on qualifying certain intangible expenses for deduction.

As stated earlier, the form of the application is still in the process of being prepared by the Department. Hopefully, the Department will circulate that form for comments before finalizing the questions and scope of information required by the application.

If you would like to discuss this 2012 Statute and how it may affect your business, please contact one of the attorneys in the Firm's Tax Department.