

PUBLICATION

Spotlight on Tennessee: Governor Signs IMPROVE Act to Fund Infrastructure, Reduce Taxes

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The 2017 Legislative Session is in the final stretch. However, one of the most important votes this Session has already occurred with the passage of the Governor's legislative initiative to assist in funding State and local transportation infrastructure needs while at the same time addressing various tax inequities.

When initially proposed by Governor Haslam in late January, this initiative was called the Improving Manufacturing, Public Roads and Opportunities for a Vibrant Economy Act (the 'IMPROVE' Act). Later, the additional title "2017 Tax Cut Act" was added by the Legislature so as to recognize the several tax inequities addressed, many by amendments, in the final text of the Act.

Governor Haslam signed the Act on April 26, which is now 2017 Public Chapter No. 181.

I. Overview

A brief overview is as follows of certain significant provisions within the Act:

A. State Transportation Infrastructure Projects and Funding. The Act specifically lists 962 road and bridge projects across the State which, at some point, will be funded in whole or in part by sources within the Act. These projects impact all of Tennessee's 95 counties in varying degrees.

Funding sources include several taxes and fees, with the principal sources being an increase over three years in the gas and diesel taxes. The current 20¢ per gallon gas tax will be increased to 24¢ effective July 1, 2017, then to 25¢ effective July 1, 2018 and finally 26¢ effective July 1, 2019. Similarly, the current 17¢ per gallon undyed diesel tax will increase to 21¢ effective July 1, 2017, 24¢ effective July 1, 2018 and 27¢ July 1, 2019. An existing 1.4¢ per gallon license tax and fee will continue to be added to both gas and diesel taxes. See Notice #17-18 just published by the Tennessee Department of Revenue as to dyed diesel fuel.

Tax on certain alternative fuels would also increase over three years. Currently at 14¢ a gallon, the liquefied gas tax would increase to 17¢ per gallon effective July 1, 2017, 19¢ per gallon effective July 1, 2018 and 22¢ per gallon effective July 1, 2019. Compressed natural gas currently at 13¢ per gallon would increase to 16¢ effective July 1, 2017, 18¢ effective July 1, 2018 and 21¢ effective July 1, 2019. Other fees and taxes are also imposed or increased to assist with this funding, such as a \$100 registration and renewal fee with respect to electric vehicles.

The Legislature expressed its intent that these 2017 increases shall be used for the above-referenced transportation and related projects.

B. Local Option Transit Surcharge. The local surcharge provisions within the Act were the subject of intense deliberations and discussions among interested parties prior to the Act's approval by the Legislature. As

enacted, several counties and cities are authorized under the Act to adopt their own local surcharge for purposes of funding a local "transit improvement program" – provided that the surcharge is approved by a majority of the number of registered voters of the local government voting in an election on the surcharge question.

Those local governments to which these provisions apply include: (i) any county in Tennessee (including any county having a metropolitan or consolidated form of government) with a population in excess of 112,000 according to the 2010 Federal census; and (ii) any city in this State having a population in excess of 165,000 according to such census. The applicable counties would thus include, among several others, Davidson, Hamilton, Knox, Rutherford and Shelby; and the cities would include Chattanooga, Knoxville, Memphis and Nashville.

A local "transit improvement program" consists of specified public transit system projects and services, with the term public transit system including any mass transit system intended for shared passenger transport services to the general public – together with any building, structure, vehicles, etc. – needed to operate the transportation facility or provide connectivity for the facility to any interstates, highways, roads or other non-mass transit system transportation infrastructure.

Further, the term "surcharge" means a tax, or combination of taxes, levied by a local government for said funding purposes; however, any such surcharge is limited to the following local privilege taxes:

- (1) Local options sales and use tax (enacted per State law);
- (2) Business tax (enacted per State law);
- (3) Motor vehicle tax (enacted per State law or by applicable private act);
- (4) Local rental car tax (enacted per State law);
- (5) Tourist accommodation tax (enacted per State law, or hotel occupancy tax per State law, or by applicable private act); and
- (6) Residential development tax (per the County Powers Relief Act per State Law).

In essence, if approved through the election process referenced above, those authorized local governments can impose a surcharge coexistent with any one of the above-referenced six taxes. The Act provides that any surcharge shall be levied, collected and administered in the same manner as the applicable underlying local tax, and shall be subject to the same conditions, limitations, exemptions, credits, returns and other requirements as are applicable to the underlying local tax.

The rate of a surcharge under the Act depends upon the maximum rate established for a particular surcharge. For instance, a surcharge on the local option sales and use tax may not exceed the maximum rate established for the applicable underlying local option sales and use tax. Additionally, no local government may levy a surcharge on a business tax, a surcharge on a local rental car tax or surcharge on a residential development tax that separately exceeds the rate of 20 percent of the current applicable rate of the business tax, local rental car tax or residential development tax. Still further, no local government may levy any combination of the tourist accommodation taxes, hotel occupancy taxes, local tourism development zone business taxes, state sales and use taxes, local option sales and use taxes, or surcharges on any combination of tourist accommodation taxes, hotel occupancy taxes, and local option sales and use taxes that exceed a combined rate of 20 percent on hotels, motels or other tourist accommodations which are subject to such taxes and surcharges.

There are several exemptions and/or limitations specifically referenced in the Act which would be applicable to a surcharge on the local option sales and use tax, as well as certain of the other surcharges.

The Act provides that a taxpayer shall have the same remedies applicable to the underlying local tax with respect to which the surcharge is imposed. Further, with respect to surcharges that are administered and collected by the Department, the Act states that the law which applies to the recovery of the underlying taxes illegally assessed or collected be conformed to apply to the recovery of surcharges illegally assessed or collected.

For any surcharge that the Department administers and collects, the Act states that the Department shall have the same powers in regard to the underlying local tax and shall remit the proceeds of the surcharge to the local government less an administrative fee.

C. Tax Inequities Addressed by the Act. The tax inequities (that is, rate cuts or other types of tax decreases) addressed by the Act include the following:

- (1) **Sales Tax on Food Reduced.** Continuing the General Assembly's intent to reduce the sales tax on food and food ingredients for human consumption, the Act further reduces the sales tax from its five percent rate to four percent effective July 1, 2017. See the Department's Notice #17-07 addressing this tax rate reduction.
- (2) **Hall Tax Rate Reduced/Then Eliminated.** The General Assembly in 2016 reduced the Hall income tax rate from its historic six percent to five percent effective January 1, 2016. Additionally, the General Assembly last year expressed its intent to continue reducing this tax rate such that the Hall income tax is eliminated for tax years that began on or after January 1, 2022. In furtherance of the foregoing, the Act provides that the rate of the Hall income tax will be four percent for tax years beginning on or after January 1, 2017, three percent for tax years beginning on or after January 1, 2018, two percent for tax years beginning on or after January 1, 2019, one percent for tax years beginning on or after January 1, 2020 and zero percent for tax years beginning on or after January 1, 2021.
- (3) **Single Sales Factor Apportionment Formula for Manufacturers.** Effective for tax years beginning on or after January 1, 2017, a taxpayer whose "principal business in Tennessee is manufacturing" may elect to apportion net earnings for excise tax purposes and may elect to apportion the net worth for franchise tax purposes pursuant to a single sales factor. That single sales factor is in essence a fraction, the numerator of which is the total receipts of the taxpayer in Tennessee during the taxable year and the denominator of which is the total receipts of the taxpayer from any location within or outside this State during the taxable year.

The phrase "principal business in Tennessee is manufacturing" is defined to mean that more than 50 percent of the revenue derived from the taxpayer's activities in Tennessee (excluding passive income) is from fabricating or processing tangible personal property for resale and consumption off the premises. The phrase "passive income" means dividend income, interest income, income derived from the sale of securities and income derived from the licensing or sale of patents, trademarks, trade names, copyrights, know-how or other intellectual property.

In order to elect use of the single sales factor apportionment formula for either tax, the taxpayer must notify the Department of the election, in writing, on its Franchise, Excise Tax Return for the taxable year to which the election applies. Once an election is made, that election shall remain in effect for a minimum of five tax years and thereafter until revoked.

A taxpayer wishing to revoke an election after the minimum five years must notify Department of the revocation, in writing, on its Return for the first taxable year to which the revocation applies. That same "first taxable year" concept is not included in the election provisions of the single sales factor, bringing into question whether the election notification must be on each Return during the election period.

A taxpayer that revokes the single sales factor election shall not be permitted to newly elect this single sales factor method for a period of five years, beginning with the tax year in which the taxpayer revoked the previous election.

Specifically with respect to the franchise tax, the Act includes an additional provision making the single sales factor operative only if the Tennessee State Funding Board certifies that all payments have been made on bonds issued by the State as of July 1, 2013 which are still outstanding, that the State is not in default in payment of any debt or interest on said bonds, and that the fees and taxes which are to be lowered (one of which being the franchise tax pursuant to this single sales factor apportionment election) will still be sufficient to provide funds adequate to meet all payments required by the State Funding Board, as well as provide for other obligations of the State. Hopefully that certification from the State Funding Board will always be forthcoming.

Also specifically as to the franchise tax, please note that this elective single sales factor apportionment formula does not compromise or otherwise impact a taxpayer's franchise tax liability computed under the minimum measure of the franchise tax base.

(4) Property Tax Relief for Certain Taxpayers. Continuing with the General Assembly's efforts almost each year to assist certain taxpayers with respect to their property taxes, the Act provides that: (i) for taxpayers 65 years of age or older, having an annual income from all sources not exceeding \$24,000, reimbursement from the State shall be paid on the first \$27,000 (up from \$23,500) of the full market value of the taxpayer's property, and beginning in 2018 such amount shall be increased annually to reflect inflation as measured by the U.S. Bureau of Labor Statistics Consumer Price Index; (ii) for taxpayers who are totally and permanently disabled, having an annual income from all sources that does not exceed \$24,000, reimbursement from the State shall also be paid on the first \$27,000 (again up from \$23,500) of the full market value on the taxpayer's property, and also increasing beginning next year as measured by the CPI; and (iii) for disabled veteran taxpayers, reimbursement from the State shall be paid on the first \$175,000 (up from \$100,000) of the full market value of the taxpayer's residence. These provisions are effective under the Act on July 1, 2017.

II. Summary

This Act, whether called the IMPROVE Act or the 2017 Tax Cut Act, contains numerous provisions that are highly complex, in particular the local transit surcharge provisions. As a result, please consult your tax advisor pertaining to your specific facts and circumstances.

For more information regarding the topics addressed in the Act, please contact the author, [Carl Hartley](#), or [William Fones](#), or [Steve K. Wood](#) in our Tennessee offices of the [Firm's Tax Group](#).