PUBLICATION

Spotlight On Tennessee: Proposed Changes to Tennessee's Tax Laws

May 23, 2008

On May 15, 2008 the Tennessee Department of Revenue's technical corrections bill (Bill) passed both the Senate and the House as an amendment to Senate Bill No. 4173. Signatureby the Governor is expected.

The Bill amends portions of Tennessee's tax laws and presents several significant changes that affect individuals and business owners. Several of the noteworthy changes are highlighted below.

Sales and Use Tax

Digital Downloads: The Department's Bill establishes new provisions for application of the sales and use tax to digital downloads of songs, books and movies. Under the Bill, the retail sale, lease, licensing or use of the following three categories of digital downloads will specifically be subject to those new provisions as of January 1, 2009: (i) "Digital audio-visual works," including motion pictures, musical videos, news and entertainment programs and live events; (ii) "Digital audio works" including prerecorded or live songs, music, readings, speeches, ringtones or other sound recording; and (iii) "Digital books," meaning works generally recognized as "books" which are transferred electronically. The Bill carves out from taxation subscriptions to satellite radio services, newspapers, magazines, periodicals, chat rooms discussions and blogs. **Please note:** The Department announced, concurrent with debate regarding the Bill, that many if not all of such downloads are considered currently to be taxable, and that these new provisions are simply clarifications of existing law. Some Tennesseans have already been paying tax to vendors of digital downloads.

Headquarters Facility: The Bill exempts from sales and use tax any property moved by a taxpayer to Tennessee in conjunction with establishing a headquarters facility in this state so long as the tangible personal property had been used by the taxpayer in the operation of the business outside Tennessee. This exemption applies to any sales or use taxes arising solely as a result of moving such property to Tennessee.

Computer Software: The Bill clarifies Tennessee's tax laws to specifically provide for the imposition of sales tax to the lease or rental of computer software where the lease or rental of the software is part of a regularly established business. In addition, the Bill clarifies that charges for repair services to computer software and charges for the installation of computer software are subject to sales taxation.

Food Purchased by Hotels: ***The proposal discussed in this paragraph was part of the Department's original version of the Bill, but was removed during the last few days prior to consideration by the Senate Finance Ways and Means Committee. Nevertheless, this proposal may be of interest because it may reappear in the future.*** Under the Department's original wording of the Bill, a modification was proposed to address the taxability of food, beverages and other items provided by hotels and motels to guests as part of the room rate. Under the Department's proposal, lodging establishments which provide food and beverages to guests at no additional charge are deemed to be the users of food and beverages provided to guests, which would have resulted in the tax being due from those establishments on their initial purchase of such items.

Franchise and Excise Taxes

Separate Excise Tax on Gain from Sale of Property: Since 2004, and independent from the general business excise tax, the Department administers a separate 6.5% excise tax found at Tennessee Code Annotated, Section 67-4-2007(f). Currently, that separate excise tax applies under certain statutorily specified circumstances to the gain from the sale of an asset by an entity or individual not already subject to the general excise tax. If the selling entity or individual is exempt or not subject to the general excise tax but received or holds the asset under one of those specified circumstances during the immediately preceding twelve month period, the gain on the sale of the asset is subject to the separate excise tax. However, the Department apparently determined that the separate excise tax was still being avoided where multiple transfers occurred in advance of the sale. As a result, the Bill provides that the separate tax will also apply if the asset was owned during the twelve month period immediately prior to the sale, by an affiliate subject to the general excise tax.

Captive REITs: The Bill imposes a new requirement for financial institutions to disclose dividends received from a captive real estate investment trust to the Department. Failure to make the disclosure will result in disallowance of the dividends received deduction and a corresponding adjustment of earnings, in addition to a 50% penalty on the amount of any underpayment arising from the adjustment.

Incentives for Business: The Bill makes several changes that amplify current tax incentives for franchise and excise tax purposes, some of which are as follows:

1. The Bill revises the time period for an entity to make a $1 billion required investment in order to qualify for the higher jobs tax credit. Currently, an entity has to make that investment within three years from the filing of the business plan. Upon good cause shown, that three year period can currently be extended for up to two additional years. The Bill provides for the extension to not exceed four years.
2. The commissioners of revenue and economic development are authorized under the Bill, when in the "best interests of the state," to extend the current fifteen year period of time for a taxpayer utilizing a net operating loss carryover where the taxpayer has qualified for the jobs tax credit and has made a required capital investment in excess of $100 million.
3. The sunset on the jobs tax credit against a taxpayer's franchise and excise tax liability is extended from January 1, 2011, to January 1, 2016.
4. The Bill allows an "integrated supplier" as defined by the Bill to be eligible for the jobs tax credit regardless of the level of investment.
5. The jobs tax credit and other incentives are authorized for taxpayers who meet the Bill's definition of a "certified green energy supply chain manufacturer."

Family-owned Non-corporate Entity (FONCE) Exemption: ***The proposed changes described in this paragraph were hotly contested and ultimately removed from the Department's Bill just prior to consideration by the Senate Finance Ways and Means Committee; however, these changes are nevertheless discussed herein because the Department may again propose similar wording in the future.*** Under the current law, FONCE allows a non-corporate entity to claim exemption from the franchise and excise tax if it is family owned (at least 95% of the ownership units of the entity are owned by members of the family), and if substantially all (66.67% of the gross receipts) of the activity of the entity is the production of passive investment income or a combination of the production of passive income and farming. Passive investment income currently includes "rents" as well as royalties, dividends, interest, annuities, and gains on the sale or exchange of stock or securities. The Department's proposal would have considerably limited "rents" by redefining passive investment income for such purposes as only including "rents from residential property or farm property," and effectively excluding rents from commercial property. As stated above, these changes to the definition of "rents" are not part of the Bill as passed by the Senate and House; however, a new, separate amendment was included in the Bill which requires entities exempt under FONCE to report information to the Department on forms that the Department prescribes so that the Department can make a report to the

Legislature not later than January 20, 2009, as to the utilization, costs and benefits of FONCE and recommendations as to continuing FONCE.

Gift Tax

This proposed change was also removed from the Bill as passed by the Senate and House, but could well be part of a future bill. In an effort to make Tennessee's gift tax provisions consistent with federal law, the Department's Bill originally proposed eliminating the classification of gift recipients under Tennessee's existing gift tax provisions. Under current law, donors may give up to $12,000 annually free of Tennessee gift tax to Class A beneficiaries, which include spouses, children and other lineal ancestors and descendants. In contrast, gifts free of such tax to Class B beneficiaries, which include all other recipients, are currently limited to a lesser amount. The Department's original wording would have removed the distinction between Class A and Class B beneficiaries so as to permit a donor to give up to $12,000 annually (the same amount as the federal annual exclusion gift amount) to any beneficiary.

Other Changes

The Department's Bill includes numerous other changes, such as the following:

6. The Department is authorized to enter into a managed compliance agreement with an "eligible" taxpayer (as defined in the Bill) which is benefiting from the headquarters sales tax credit or certain other sales tax credits, so that such taxpayer can have more freedom in managing the application of those credits -- such as by the use of a direct pay permit issued by the Department to purchase tangible personal property without paying sales tax to its vendor and instead remitting the applicable tax directly to the Department.
7. In an effort to increase efficiency through electronic filing, the Department is authorized to require a party filing electronically for one retail location to also file electronically for all locations.
8. The filing of tax returns, reports, statements, remittances or other tax documents through "designated delivery services" (as defined in Section 7502 of the Internal Revenue Code, which would include FedEx and UPS) are accorded the same 24-hour grace period that currently applies to filing by U.S. Mail.