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## 2009 Tennessee Tax Legislative Update

By Joseph W. Gibbs, Patricia Head Moskal and Brian S. Shelton

### Senate Bill 2318/House Bill 2275 – “Technical Corrections Bill”

The Tennessee General Assembly passed Senate Bill 2318/House Bill 2275, the Administration’s tax legislation referred to as the “Technical Corrections Bill,” on June 17, 2009 (the “Bill”). The Bill is awaiting Governor Bredesen’s signature, which is expected. A few highlights of the major provisions of the Bill include:

- A substantial narrowing of the exemption from franchise and excise tax for family-owned non-corporate limited liability entities (known as the “FONCE” exemption).
- Numerous revisions to the job tax credit and other tax incentives for businesses bringing new or expanded facilities and jobs to Tennessee.
- Revisions to the sales and use tax laws, including a two-year extension of the effective date of many of the Streamlined Sales Tax provisions until July 1, 2011.
- Overhaul of the business tax code, with collection of the business tax transferred from county clerks to the Commissioner of Revenue to improve efficiency and enforcement.

Notably, the Senate rejected several other revenue provisions originally proposed by the Administration in its Technical Corrections Bill. Among the deleted proposals were the following:

- A proposal to require hotels and motels to pay sales tax on “free” or complimentary food and beverages included in the room rental rate for their guests, instead of purchasing such food and beverages on a resale certificate. This proposal would have overruled the Tennessee Court of Appeals’ decision in *Nashville Clubhouse Inn v. Johnson*, 27 S.W.3d 542 (Tenn. Ct. App.), *perm. app. denied* (Tenn. 2000).
- A proposal to increase the tax paid by business customers on interstate and international telephone services from 7.5% to 9.5%.
- A proposal to tax home television equipment, such as cable TV boxes, provided by cable or satellite TV companies, which currently is not subject to sales and use tax.

The following is a more detailed summary of the principal provisions of the final version of the Technical Corrections Bill as passed by the Tennessee General Assembly.

### FRANCHISE AND EXCISE TAXES

#### *FONCE Exemption and Other Statutory Exemptions*

- To qualify for the family-owned non-corporate entity (“FONCE”) exemption from franchise and excise taxes, substantially all of the activity of the limited liability company or limited partnership must be the production of passive investment income or farming. Previously, “rents” were included in the definition of “passive investment income.” The Bill deletes “rents” from the definition and substitutes “rents from residential or farm property.” Property tax definitions of “residential” and “farm property” are adopted with certain modifications. The property tax definition of residential property excludes any property with two or more rental units. For purposes of the FONCE exemption, residential property includes residential property with not more than 4 rental units.

“Farm property” is defined as not including acreage used for recreational purposes by clubs including golf course playing hole improvements. The principal impact of these amendments to the FONCE exemption is that limited liability companies and limited partnerships that have substantial rental income from commercial property or multi-unit residential property will no longer qualify for the exemption. The effective date of the amendment is July 1, 2009.

#### ***Obligated Member Entities/ FONCE Transitional Relief***

- “Obligated member entities” are limited partnerships, limited liability companies, and registered limited liability partnerships that have filed appropriate documentation with the Secretary of State to provide that the partners or members are liable to the same extent as if they were general partners. An obligated member entity is exempt from franchise and excise tax for its entire tax year if it makes the required filing on or before the first day of its tax year. Under the Bill, entities formerly exempt under the FONCE exemption can continue to be exempt by filing by October 1, 2009 the documentation required to be an obligated member entity, but the members or partners would no longer have limited liability. Entities that are calendar year entities and timely file the required documentation will be exempt for the calendar year 2009. The Bill does not provide similar transitional relief for FONCEs that convert to general partnerships.

#### ***Limitation on Rent Deduction***

- A new provision is added limiting the deductibility, for excise tax purposes, of rents from industrial and commercial property paid to an affiliate, to the extent the rent exceeds 2% per month of the appraised value of the property.

#### ***Exempt Entity Reporting***

- The Bill requires taxpayers claiming certain exemptions from franchise and excise taxes to file an application for exemption within 60 days of the beginning of the first tax year for which the exemptions are claimed. Taxpayers that previously have claimed franchise and excise tax exemptions are required to file an annual application for renewal of the exemption on or before the 15th day of the 4th month following the close of the taxpayer’s tax year. Entities that do not file the required application or renewal applications do not qualify for exemption. The Commissioner may accept an untimely filed application, but a penalty of \$1,000 per occurrence is imposed for the failure to file the required application for exemption and the application for renewal of exemption.

#### ***Captive REIT Dividend and Intangible Expense Reporting***

- Financial institutions are required to report the receipt of dividends from captive real estate investment trusts (“REITs”), and taxpayers that deduct expenses relating to intangibles owned by affiliates are required to report the dividends or expenses, as the case may be, on the taxpayers’ franchise and excise tax returns. Failure to report the dividend or expense results in the disallowance of the deduction, and a penalty may be imposed if the failure is determined to be due to negligence. The Bill establishes the amount of the penalty for negligent failure to disclose to be the greater of \$10,000 or 50% of the deduction.
- The Bill also amends the definition of a “publicly traded REIT” for franchise and excise tax purposes to clarify that the entity must be traded on a regulated national securities exchange of the United States or of a foreign country.

### **ECONOMIC INCENTIVES**

#### ***Job Tax Credit***

- The amount of the job tax credit is increased from \$2,000 per job to \$4,500 per job. Prior law permitted a job tax credit of \$4,500 per job only in “economically distressed counties,” which term was changed to “enhancement county” in the Bill. The amendment provides that the \$4,500 per job tax credit is allowed for qualified jobs created in all counties.
- The amount invested in computer software is included in the definition the “required capital investment” necessary to qualify for the job tax credit.

- To qualify for the job tax credit, a business must make the required capital investment within 12 months of the effective date of the business plan and create at least 25 jobs.
- The job tax credit may offset not more than 50% of the combined franchise and excise tax, as compared to prior law that allowed a percentage of the franchise and excise tax liability ranging from 33 1/3 % to 100% to be offset by the job tax credit based on the number of jobs created.
- The additional annual credit provision based upon an investment of at least \$1 billion in the state previously required the creation of at least 1,000 jobs. The minimum job requirement is reduced to 500 jobs.

#### ***Extension of Incentives to Suppliers, Customers and Affiliates***

- The green energy tax credit is extended to integrated suppliers, integrated customers and campus affiliates of certified green energy supply chain manufacturers, and the carbon charge tax credit is extended to campus affiliates, as follows:
  - “Integrated suppliers” that provide goods and services to a certified green energy supply chain manufacturer making an investment of at least \$1 billion in the state, and are located within the “footprint” of the manufacturer’s project site can qualify for the green energy tax credit;
  - “Integrated customers” that purchase materials from a certified green energy supply chain manufacturer making an investment of at least \$1 billion in the state, and are located within the “footprint” of the manufacturer’s project site can qualify for the green energy tax credit;
  - “Campus affiliates” which are entities affiliated with a certified green energy supply chain manufacturer making an investment of at least \$1 billion in the state, and are located within the “footprint” of the manufacturer’s project site can qualify for the green energy tax credit and the carbon charge tax credit.
- The definition of “integrated supplier” is revised to provide that the supplier is required to provide goods and services primarily to the supported manufacturer rather than *exclusively* to the supported manufacturer as under prior law.

#### ***Industrial Machinery Credit***

- For taxpayers making an investment of at least \$1 billion in the state, the carryover period for industrial machinery credits may be extended indefinitely until the credits are fully utilized.
- The investment period for taxpayers making expenditures of at least \$1 billion in the state may be increased from a maximum of 5 years to a maximum of 7 years.
- The amounts expended on owned or leased computer software are included in determining the required capital investment to qualify for the increased levels of the industrial machinery credit.

#### ***Headquarters Relocation Credit***

- The headquarters relocation credit is increased from \$50,000 to \$100,000 per job for taxpayers that invest at least \$1 billion in the state, and the minimum number of jobs that must be created is reduced from 1,000 to 500.
- The Bill prorates the recapture of the credit with respect to headquarters facilities that are not used for a headquarters facility for the full 10-year period.

#### ***Required Capital Investment – Computer Software***

- The amounts expended on owned or leased computer software are included for the purpose of determining if a taxpayer has made the required capital investment necessary to qualify for the data center credit, the job tax credit, the headquarters facility credit, the emerging industry credit, and the industrial machinery credit, and constitutes qualified property for the purpose of calculating the headquarters facility credit and the emerging industry credit.

#### ***Qualified Data Center Investment Period***

- The investment period for “qualified data centers” to meet the required capital investment is increased from a maximum of 5 years to a maximum of 7 years.

### ***Emerging Industry Credit***

- Taxpayers that establish qualified facilities to support an “emerging industry” are eligible for sales and use tax credits. An “emerging industry” previously was defined to be an industry that promotes high-skill, high-wage jobs in high-technology areas, or emerging occupations, but excluded taxpayers primarily engaged in certain businesses, including manufacturing. The Bill expands the definition of an “emerging industry” to add “clean energy technology,” including research and development, removes the exclusion for manufacturing and certain other businesses, and increases the investment period from 6 to 8 years.

## **SALES AND USE TAXES**

### ***Streamlined Sales Tax – Extension of Effective Date***

- The implementation of the remaining Streamlined Sales Tax provisions is delayed for two additional years, from July 1, 2009 to July 1, 2011.

### ***Computer Software Maintenance Contracts***

- Charges for the following are subject to sales tax: (i) computer software maintenance contracts that are sold as a part of computer software that is subject to sales tax; (ii) computer software maintenance contracts with respect to computer software installed on computers located in Tennessee; and (iii) computer software maintenance contracts where the purchaser’s address is in Tennessee if the location of the computer software is unknown.
- The Bill provides that the exemption for self-created computer software does not apply to computer software that is fabricated by an agent of the taxpayer unless the agent is a direct employee of the taxpayer. This amendment overrules the recent Tennessee Court of Appeals’ decision in *Teksystems, Inc. ex rel. Maxim Group, Inc. v. Farr*, 2009 WL 1312835 (Tenn. Ct. App. May 11, 2009).

### ***Advertising***

- The Bill adds a statutory provision to clarify the application of sales and use taxes to advertising services and advertising materials. Sales and use taxes apply to final artwork and advertising materials, but do not apply to preliminary artwork produced by an advertising agency for the purpose of conveying concepts or ideas. The effect of the Bill is to clarify that sales tax does not apply to charges for advertising services regardless of whether the advertising agency creates and transfers preliminary artwork to its clients incident to providing advertising services. Statutory definitions of “advertising agency,” “advertising materials,” “advertising services,” “preliminary artwork,” and “final artwork” are added. The definitions specifically provide that original sound or video recordings produced by recording studios, television studios, video production studios, by or for advertising agencies, or masters produced from such recordings, do not constitute final artwork or advertising materials.

## **OTHER TAX PROVISIONS**

### ***Privilege Tax on NBA and NHL Players***

- The Bill imposes an annual privilege tax on players who are employed by and on the roster of any franchise of the National Basketball Association or National Hockey League for any NBA or NHL regular season game held in Tennessee. The tax is \$2,500 per game with a three game annual maximum.

### ***Business Tax – Administered by Commissioner of Revenue***

- The Bill substantially rewrites the business tax provisions and shifts responsibility for administering the business tax from county clerks to the Commissioner of Revenue. Notable changes in the business tax code include:
  - Classifying businesses as retailers or wholesalers based on their dominant business activity for the purpose of determining the tax rate;
  - A new definition of “resale;”
  - Revised provisions applicable to contractors and subcontractors, including requirements for contractors to obtain documentation with respect to subcontractors;
  - A new provision for the deduction of bad debts;
  - Revised provisions for the credit for personal property taxes, including a limitation of 50% on the amount of business tax that may be offset by the credit;
  - Provisions for filing returns and paying taxes electronically.

#### ***Participation in Multistate Tax Commission Joint Audit Program***

- The Commissioner of Revenue is authorized to enter into a contract to participate in the Multistate Tax Commission Joint Audit Program and to disclose tax return and other tax information for the purpose of participating in that program.

#### ***Inheritance Tax Returns – Requests for Extension***

- Automatic extensions of twelve months to file and pay the Tennessee inheritance tax are to be granted. An automatic extension is obtained upon request of the personal representative or by providing a copy of the personal representative’s request for an automatic extension of time to file the federal estate tax return. The request for extension is to be attached to the Tennessee inheritance tax return when filed on or before the extended due date, and not on or before the original due date of the return. Interest accrues on the unpaid amount of inheritance tax due from the original due date until the date the tax is paid. Penalties are imposed only if the taxpayer fails to file the request for extension or fails to file a return and pay the tax by the extended due date.

#### ***Tax Remedies – “Prevailing Party” Attorneys’ Fees***

- The state will be deemed the “prevailing party” for purposes of awarding reasonable attorneys’ fees and expenses of litigation in any case in which the taxpayer has been found by the court to have committed fraud. This amendment overrules the decision reached by the Tennessee Court of Appeals in *Davis Enterprises, LLC v. Farr*, 2008 WL 4998411 (Tenn. Ct. App. Nov. 25, 2008).

#### **Property Taxes**

- Minor changes are made with respect to the procedure for redemption of property and for the correction of forced assessments.
- Qualified commercial financing entities are defined and are removed from the intangible property tax provision that assesses stockholders on shares of stock in lieu of assessing the corporation on its capital stock.
- Prosthetic surgical kits are deemed to be “inventories of merchandise held by merchants and businesses for sale or exchange” as the typical stock on hand at the premises of the merchant or owner or when held for 30 days or less by a customer for use in surgeries.

#### **EFFECTIVE DATES**

The last section of the Bill sets forth the various effective dates.

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