

State and Local Tax Bulletin

March 31, 2010
Tennessee Edition



Tennessee Update: Sales and Use Taxes and Business Tax

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

Upcoming Seminars Involving Members Of Our SALT Practice Group

April 25 – 29, 2010

Council On State Taxation – 2010 Intermediate/Advanced State Income Tax School, Atlanta, Georgia. Chris Grissom will be a co-speaker with Kent Clay of Deloitte Tax on the State Taxation of Pass-Through Entities and Their Corporate Owners. For more information, please visit the COST website: www.cost.org.

May 3, 2010

Tax Executives Institute, Houston Chapter. Chris Grissom will be speaking on the "State Taxation of Pass-Through Entities." For more information, please visit the TEI website: www.tei.org.

May 13-14, 2010

ASCPA Business and Industry Conference, Montgomery, Alabama. Jimmy Long and Will Thistle will be speakers in a presentation on "Recent Alabama Tax Developments". For more information, please visit the ASCPA website: www.ascpa.org.

May 25, 2010

COST's Southeast Regional Update will be held in Birmingham, Alabama at Energen Corp. headquarters from 8:00 a.m. to 1:30 p.m. This seminar will present updates on significant state tax issues for the Southeast States: Alabama, Arkansas, Florida, Georgia, Mississippi, North Carolina, South Carolina and Tennessee. For more information, please visit the COST website: www.cost.org.

May 26, 2010

Lorman Education Services. Joe Gibbs will be one of the speakers at the Tennessee "Sales and Use Tax" seminar to be held in Nashville, Tennessee. For more information, please visit the Lorman website at www.lorman.com/seminars.

SALES AND USE TAXES: JUDICIAL DEVELOPMENTS

Security Monitoring Equipment Subject to Use Tax; Failure to Plead Defense of Equitable Recoupment Results in Waiver. The Tennessee Court of Appeals recently upheld a use tax assessment on security monitoring equipment in *ADT Security Services, Inc. v. Johnson*, 2009 WL 4017165 (Tenn. Ct. App. Nov. 19, 2009). The case is not yet final, however, as the taxpayer has filed an application for permission to appeal to the Tennessee Supreme Court.

The taxpayer, ADT Security Services, Inc. ("ADT"), sold security and monitoring services to residential and commercial customers. In providing those services, ADT purchased monitoring equipment without paying sales tax, asserting that the equipment was purchased for resale to its customers as leased equipment. At the time of the resale or lease of the equipment, ADT charged its customers a one-time, non-itemized installation fee on which ADT collected and remitted sales tax to the Tennessee Department of Revenue.

The Department disagreed with the taxpayer and assessed use tax against ADT, claiming that ADT used the monitoring equipment to provide security services to its customers and, therefore, did not purchase the equipment for resale. ADT sued to challenge the assessment.

At trial, ADT argued that its installation charges included charges for the lease of the monitoring equipment and sales tax was remitted in the amount that would have been due had ADT charged separately for the lease and installation of the equipment. In closing argument, ADT asserted – for the first time – that even if the court found that ADT owed use tax on the equipment, ADT was entitled to a credit or offset in the amount of sales tax remitted on the installation charges under the doctrine of equitable recoupment.

The Department responded that ADT had failed to prove that it leased the monitoring equipment to its customers, and that the evidence instead proved that ADT installed and used the monitoring equipment in the fulfillment of its security services contracts. The Department further argued that the one-time installation charge proved only that ADT charged its customers for the installation of a security system and not for the lease of the equipment.

The trial court agreed with the Department, and held that ADT used the monitoring equipment to provide security services and did not lease the equipment to its customers. However, the trial court agreed with ADT that it was entitled to equitable recoupment, and allowed ADT to offset the use tax by the amount of sales tax remitted on the installation charges.

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On appeal, the Court of Appeals affirmed the trial court's decision in part and reversed it in part. The appellate court affirmed the trial court's ruling that ADT failed to prove that the monitoring equipment was exempt from use tax as equipment purchased for resale. The appellate court reversed the trial court's ruling that ADT was entitled to equitable recoupment, rejecting the right to offset on procedural grounds. The appellate court explained that the doctrine of equitable recoupment is an affirmative defense that must be plead prior to the close of proof at trial. Because ADT did not raise that affirmative defense until closing argument, after the close of proof, ADT was deemed to have waived it.

ADT filed a petition for rehearing with the Court of Appeals, which was denied. ADT's application for permission to appeal to the Tennessee Supreme Court (Docket No. M2008-02008-SC-R11-CV), is pending.

Supreme Court Grants Review of Sale for Resale Exemption on Purchase and Lease of Airplane. The Tennessee Supreme Court granted the Department of Revenue's application for permission to appeal a decision setting aside a use tax assessment on an airplane purchased outside the state, brought into Tennessee, and leased to a related entity in *CAO Holdings, Inc. v. Chumley*, 2009 WL 1492230 (Tenn. Ct. App. May 27, 2009), *perm. app. granted* (Docket No. M2008-01679-SC-R11-CV) (Tenn. Jan. 25, 2010). Both the trial and appellate courts had ruled in favor of the taxpayer, holding that the taxpayer had purchased the plane for resale and, therefore, was not subject to use tax.

The taxpayer, CAO Holdings, Inc. ("CAO"), was wholly-owned by one individual. CAO purchased the airplane and immediately leased it to CAM Management, Inc. ("CAM"), a separate corporation wholly-owned by the same individual. At the time of purchase, CAO provided the seller with a resale certificate, evidencing that the airplane was purchased for resale and relieving the seller from collecting sales tax.

CAO and CAM entered into a "Non-Exclusive Aircraft Lease Agreement" that required CAM to pay CAO a rental amount per flight hour of use. CAO claimed that the purpose of the lease was to isolate any potential tort liability while allowing CAM to facilitate a time-sharing business for the airplane's use. Under the lease, CAO was allowed to lease the airplane to other entities; CAM's possession of the airplane remained subject to use by CAO and other non-exclusive lessees; CAO retained the sole discretion to approve or deny flight scheduling requests by CAM; and CAM's rights to possession and use of the airplane were subordinate to CAO's rights. CAM then entered into time-share agreements with eight other entities, many of which were related to the owner

of CAO and CAM. The airplane's flight log listed CAO as the operator and the individual owner of CAO and CAM was listed as the co-pilot on a majority of flights. CAM invoiced the users of the airplane and, in turn, paid CAO for the flight hours used. CAO filed Tennessee sales and use tax returns reporting all rental income received from CAM and remitting sales tax on those amounts.

The Department maintained that use tax was owed on the purchase price of the airplane because the airplane was not purchased for resale. The Department took the position that CAO's purchase of the airplane primarily was for the use of CAO and not for lease to CAM. In support of this position, the Department relied on the fact that CAO retained various rights under the non-exclusive lease and the flight records showed that CAO was the actual user of the airplane. The Department argued that the lease was a sham for the purpose of avoiding Tennessee sales or use tax.

The Court of Appeals held in favor of CAO in a two-to-one decision. The majority found that the lease between CAO and CAM was sufficient to qualify CAO's purchase of the airplane as a purchase for resale because the statute does not require exclusive possession and there was no evidence from which to conclude that the lease between CAO and CAM was a sham such that the corporate entities should be disregarded. The dissent, however, found that CAO's control over the use of the airplane was so pervasive that it undermined any finding that leasing was the primary purpose for which the airplane was held and did not support a conclusion that the purchase of the airplane was primarily for resale.

BUSINESS TAX: ADMINISTRATIVE DEVELOPMENTS

Business Tax Administration Shifts to Commissioner of Revenue. In 2009, the Tennessee legislature substantially rewrote the business tax laws and moved responsibility for administering the business tax from county clerks to the Commissioner of Revenue. See 2009 Tenn. Pub. Acts ch. 530, § 70. As a result, business tax returns are no longer to be filed with the county clerks, but are to be filed with the Department of Revenue. Tenn. Code Ann. § 67-4-703.

The due dates for filing business tax returns with the Department are as follows:

- Classification 1 taxpayers by February 28, 2010;
- Classification 2 taxpayers by May 31, 2010;
- Classification 3 taxpayers by August 31, 2010;
- Classification 4 taxpayers by November 20, 2010; and
- Classification 5 taxpayers by February 28, 2010.

Taxpayers who are required to file sales and use tax returns electronically must also file business tax returns electronically beginning in 2010. Taxpayers who file paper tax returns must use the new form provided by the Department of Revenue and may not use the forms previously provided by the local governments. The new forms are available on the Department's website at <http://state.tn.us/revenue/forms/business/index.htm>.

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