2010 Year in Review–Developments in Tennessee Tax Laws

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

Joseph Gibbs, Patricia Head Moskal, and Brian Shelton summarize the major legislative, judicial and administrative developments in 2010 affecting Tennessee taxpayers. The Tennessee legislature, judiciary and Department of Revenue combined to create another interesting year of developments for Tennessee taxpayers and tax practitioners.

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Legislative Highlights from 2010

In recent years, Tennessee's Governor and the Department of Revenue have sponsored a single, lengthy tax bill that contains most of the administration's annual tax legislation. This annual bill is commonly referred to as the Department's "Technical Corrections Bill," which is a bit of a misnomer due to its typical complexity and multiplicity of subjects. In keeping with that tradition, Governor Bredesen and the Department of Revenue introduced the 2010 Technical Corrections Bill, which was passed by the Tennessee General Assembly on June 30, 2010 (the "Act") and has become law.[1] The General Assembly also considered and passed other tax bills during 2010. The following are highlights of the 2010 legislative changes.

Legislative Amendments Affecting Certain REITs

The 2010 Act contained multiple provisions affecting the taxation of certain real estate investment trusts (REITs), including the following:

Amended Definitions of Captive REIT and Captive REIT Affiliated Group

The Act amended the definition of "captive REIT" to reduce the ownership requirement of any other entity or individual to at least 80% (reduced from 90%) ownership

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by value determined in accordance with Generally Accepted Accounting Principles (GAAP).[2] The Act also added the term "captive REIT affiliated group," defined as a captive REIT and any entity in which the captive REIT, directly or indirectly, has more than 50% ownership interest.[3] The term "captive REIT affiliated group," however, does not include a group in which the captive REIT is owned, directly or indirectly, by a bank, a bank holding company, or a publicly-traded REIT.

Revisions to the Computation and Apportionment of the Tax Base of Captive REIT Affiliated Group

The Act revised the computation and apportionment of the tax base with respect to captive REIT affiliated groups. For excise tax purposes, the terms "net earnings" and "net loss" of a captive REIT affiliated group were amended and are now defined as the combined net earnings or loss for all members of the affiliated group computed without taking into account any dividends, receipts or expenses from transactions between the members of the affiliated group.[4] In addition, the amended definition also requires that a captive REIT (other than a captive REIT owned by a bank, a bank holding company, or a publicly-traded REIT) add back to its net earnings or net losses any federal income tax deduction taken for dividends paid to its owners for federal income tax purposes.[5] The Act added a provision requiring the apportionment of the net earnings of a captive REIT affiliated group taxable in Tennessee based on property, payroll and double-weighted receipts factors and now requires the inclusion in the apportionment formula the factors of those members of the affiliated group that would not be subject to Tennessee excise tax if considered apart from the affiliated group.[6] Transactions among members of the affiliated group are excluded from the apportionment formula.[7] For franchise tax purposes, the "net worth" of a captive REIT affiliated group is defined as the difference between the total assets and the total liabilities of the affiliated group at the close of business on the last day of the tax year as shown on a pro forma consolidated balance sheet including all members of the affiliated group prepared in accordance with GAAP.[8] Transactions and holdings between members of the group as well as holdings in non-domestic persons are eliminated for purposes of determining the net worth of the affiliated group.[9] The Act requires a member of a captive REIT affiliated group to determine its apportionment factors in the same manner as net worth is apportioned for other taxpayers computing apportioned net worth on a consolidated basis.[10]

New Requirement for Combined Reporting for Captive REIT Affiliated Group

The Act added a provision requiring a captive REIT affiliated group to designate one member of the group that is subject to tax in Tennessee to file a combined franchise and excise tax return for the entire captive REIT affiliated group.[11] The Act also provided that each member of the group subject to tax in Tennessee is jointly and severally liable for the franchise and excise tax of the affiliated group.[12]

Economic/Tax Incentive Changes

A variety of changes were made under the Act to certain tax credits and other statutory provisions that are designed to enhance the available tax incentives and encourage economic development within Tennessee. Highlights of the economic incentive changes include the following:

Creation of Nashville Medical Trade Center Credits

The Act created two refundable credits against the Tennessee franchise and excise taxes. First, a refundable credit was created for a "key tenant" equal to any "qualified medical trade center relocation expenses" incurred by the key tenant up to a maximum of $10.00 per square foot of space leased to and occupied by the key tenant.[13] The Act defined the term "key tenant" as any tenant located in the Nashville Medical Trade Center that leases and occupies a significant portion of the facility and is determined by the Commissioners of Economic and Community Development and Revenue to be essential to the initial establishment and viability of the trade center.[14] "Qualified medical trade center relocation expenses" are defined as those expenses determined by the Commissioners of Economic and Community Development and Revenue that are necessary to the creation of a permanent show room within and

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in conjunction with the initial establishment of the Nashville Medical Trade Center.[15] Second, a refundable credit was created equal to 15% of any "qualified advertising expenses" of any taxpayer who incurs and pays such expenses.[16] "Qualified advertising expenses" are defined as advertising expenses for the purpose of co-promoting the Nashville Medical Trade Center and the State of Tennessee or the City of Nashville after a determination by the Commissioners of Economic and Community Development and Revenue that the advertising and the allowance of the credit are in the best interests of the state.[17]

Extension of Headquarter Relocation Credit to Insurance Companies

The Act extended the headquarters relocation credit, which provides a credit against franchise and excise taxes for expenses incurred in relocating headquarters staff employees in conjunction with the initial establishment of a qualified headquarters facility in Tennessee, to insurance companies even though insurance companies are exempt from Tennessee excise tax. The Act provided that the credit is refundable.[18]

Election by Airline Companies Headquartered in Tennessee to Convert Unused Jobs Tax Credits to Refundable Credits

The Act allows an airline company headquartered in Tennessee that previously qualified for the headquarters facility sales tax credit to elect to convert any available and unused jobs tax credits (including the additional annual jobs tax credit) into a refundable credit, provided that the Commissioners of Economic and Community Development and Revenue determine that allowing the election is in the best interests of the state. The refundable credit is discounted to net present value using the interest rate imposed on unpaid taxes in effect on the date of the election.[19]

Commissioner Authorized to Lower Thresholds for the Jobs Tax Credit and the Headquarters Relocation Credit for Central Business District or Economic Recovery Zones

The Act authorizes the Commissioner of Revenue to lower the wage and investment thresholds applicable to the additional annual jobs tax credit (providing a credit against Tennessee franchise and excise taxes for each qualified job created by businesses making a specified capital investment in Tennessee) and to the headquarters relocation credit (providing a credit against Tennessee franchise and excise taxes for expenses incurred in relocating headquarters staff employees in conjunction with the initial establishment of a qualified headquarters facility in Tennessee). The investment must be made and the jobs created within a central business district or an economic recovery zone and the reduction of the wage and investment thresholds must be in the best interests of the state.[20]

Repeal of Sunset Provisions for Franchise and Excise Tax Credits for Film and Television Production

The Act indefinitely extended the refundable credit against the combined franchise and excise tax liability of a "qualified production company" or "qualified investor" that previously was scheduled to sunset or expire on July 1, 2012. Other than minor revisions, the Act did not alter the credit provisions and the credit remains equal to 15% of the expenses incurred in Tennessee for the production of a movie or episodic television program, provided the Commissioners of Economic and Community Development and Revenue determine that the production and the allowances of the credit are in the best interests of the state.[21]

Extension of Incentives for Green Energy Production Facilities

The Act extended an existing sales and use tax incentive and an existing property tax incentive for machinery and equipment used to produce electricity in a "certified green energy production facility," defined as a facility certified by the Department of Environment and Conservation as producing electricity for use and consumption off the premises using technology to generate energy from geothermal, hydrogen, solar and wind sources. For sales and use tax purposes, the Act extended the pollution control credit equal to 100% of the sales and use tax paid with respect to machinery and equipment used to produce electricity in a certified green energy production facility.[22] For property tax purposes, the Act extended the special rule for valuing pollution control facilities, which provides a maximum valuation of .5% of the acquisition value of applicable equipment for ad valorem property taxation, to machinery and equipment used to produce electricity in a certified green energy production facility.[23] For franchise tax purposes, the Act added a provision excluding machinery and equipment used to produce electricity in a certified green energy production facility from

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the calculation of the taxpayer's minimum franchise tax base, which measure is based on the value of the property used in Tennessee.[24]

Extension of Annual Additional Jobs Tax Credit to Integrated Customers of Certified Green Energy Supply Chain Manufacturer

The Act extended the annual additional jobs tax credit (providing a credit for each qualified job created by businesses making a required capital investment in Tennessee) to the "integrated customers" of a "certified green energy supply chain manufacturer." "Integrated customers" are generally taxpayers that purchase materials from a certified green energy supply chain manufacturer making an investment of at least $1,000,000,000 in the state, and are located within the "footprint" of the manufacturer's project site.[25]

Extension of Sales Tax Exemption for "Industrial Machinery" Includes Certain Expansions to Existing Warehouses

The Act extended the sales and use tax exemption for the purchase of "industrial machinery" to include material handling and racking systems purchased in conjunction with an expansion to an existing qualifying warehouse or distribution facility in Tennessee. To qualify for the exemption, the taxpayer must make an aggregate investment in excess of $20,000,000 over a period not exceeding three years consisting of: (1) an investment in excess of $10,000,000 in the renovation or expansion of an existing building and/or the purchase of new equipment for such building; and (2) an investment in excess of $10,000,000 in the construction of a new, previously unoccupied building and/or equipment for such building.[26]

New Credit Created for Brownfield Development Projects

The Act created a new credit against a taxpayer's combined franchise and excise taxes equal to 50% of the purchase price of Brownfield property purchased for the purpose of a "qualified development project." The term "qualified development project" is defined as a project with a minimum capital investment of $25,000,000 utilizing at least 5 acres of Brownfield property or certain "non-prime agricultural property." In the event that a taxpayer makes a minimum capital investment of at least $200,000,000, the amount of the credit is increased to 75% of the purchase price of the Brownfield property. The amount of the credit is limited to 50% of the combined franchise and excise tax liability prior to the application of the credit. Any unused credit may be carried forward for a maximum of 15 years. The taxpayer is required to file a business plan with the Commissioner of Revenue to qualify for the credit. The aggregate amount of credits available to all taxpayers is limited to $10,000,000 in any one tax year. In the event that any credits remain in a given tax year, the Commissioners of Economic and Community Development and Revenue, in consultation with the commissioner of agriculture, may open availability to qualified development projects using non-prime agricultural property.[27]

Affiliate Rent Deduction Limitation Not Applicable to Tangible Property

The Act clarified that a provision added in 2009 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, does not apply to rents from tangible personal property.[28]

Revised Definition of "Sale for Resale" for Service Providers

The Act amended the definition of "resale" to clarify that property purchased by service providers is not included in the definition of "sale for resale" when the property is used by the service provider in providing its services. The amended definition also specifically identifies other transactions that remain within the sale for resale provisions, such as (1) the sale of repair parts to a dealer for use in the dealer's performance of repair services if the property is subsequently transferred to the customer in conjunction with the dealer's performance of the repair services, (2) the sale of installation parts to a dealer if such property is subsequently transferred to the customer in conjunction with the installation of property that remains tangible personal property, (3) mobile telephones and similar devices sold to a dealer if such property is subsequently transferred to customers in conjunction with the sale of commercial mobile radio services, and (4) the sale of food or beverages to a hotel, motel or inn if such food or beverages are subsequently transferred in conjunction with the dealer's sale of lodging accommodations to a customer. The Act also clarified that the sale of taxable services (i.e., cleaning,

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maintaining or repairing services) to a dealer for use in selling, leasing or renting tangible personal property or software does not qualify as a sale for resale, and, therefore, the dealer is considered the end user of such taxable services.[29]

Disaster Relief: Sales and Use Tax Credit for Qualified Disaster Restoration Project

The Act added a sales and use tax credit equal to all sales or use taxes paid, except tax at a rate of .5%, on the purchase of "qualified tangible personal property" for building materials, machinery, equipment, computer software, furniture, and fixtures used in a "qualified restoration project." "Qualified restoration project" is defined as a project involving a minimum investment of $50,000,000 (including costs such as constructing or refurbishing a building and the cost of building materials, labor, equipment, furniture, fixtures, computer software and other personal property but not including land or inventory) for the restoration of real or tangible personal property located within a declared federal disaster area. "Qualified tangible personal property" includes building materials, machinery, equipment, computer software, furniture, and fixtures used exclusively to replace or restore real or tangible personal property damaged in the disaster and purchased or leased prior to substantial completion of the project. The Act provided, however, that a taxpayer cannot take advantage of any additional sales or use tax credits, exemptions or reduced rates otherwise available as a result of the same purchases or minimum investment.[30]

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Department of Revenue to Offset Refund Claims by Other Debts Owed to the State

On June 9, 2010, the General Assembly passed a separate bill directing the Department of Revenue to offset refunds by the amount of any debt owed by the taxpayer to a state agency, department, board, bureau, commission or authority.[31] The provisions of this bill require that any taxpayer requesting a refund in the amount of $200 or more shall complete and submit a written "Report of Debts" form. The "Report of Debts" form included in the statute requires a taxpayer to verify, subject to penalties of perjury, whether or not the taxpayer owes any of the following debts as of the date of the claim: state tax liabilities; child support; overpayment of unemployment compensation benefits; overpayment of medical assistance benefits owed the Bureau of TennCare; student loan or other obligations due to the Tennessee student assistance corporation; fees, costs or restitution owed to a clerk who serves a court of criminal jurisdiction; costs of incarceration; judgments or liens in favor of a state agency, department, commission or bureau; and all other debts owed to any other state agency, department, board, bureau, commission or authority. If the "Report of Debts" form indicates that the taxpayer owes a debt to a state agency, department, board, bureau, commission or authority, the Department of Revenue is required to offset the refund of taxes by the amount of the debt. The bill contains additional notification requirements and taxpayer's appeal rights and deadlines in the event that the Department of Revenue seeks to offset a debt against the taxpayer's tax refund. The bill states that it applies to any claim for refund filed with the Department of Revenue on or after July 1, 2009.

Judicial Highlights from 2010

Judicial tax developments during 2010 were noteworthy in at least two respects – first, the Tennessee Supreme Court, which typically hears few state tax cases, granted discretionary review to the Commissioner of Revenue in two recent cases decided in favor of the taxpayers; and second, the Department of Revenue continued its attack on taxpayers' reporting of income as nonbusiness income and therefore not subject to apportionment in Tennessee for franchise and excise tax purposes under the unitary business principle. In other interesting cases, the appellate courts reviewed the Commissioner's authority to issue a variance, the applicability of the "sale for resale" exemption in several contexts, and the procedural requirements for the defense of equitable recoupment. The following are highlights from the 2010 appellate cases.

Tennessee Supreme Court Grants Review in Case Where Capital Gains from Stock Redemption Transaction Were Held Not Taxable

Blue Bell Creameries, L.P. v. Chumley[32] is one of the two recent cases in which the Tennessee Supreme Court granted the Commissioner of Revenue's ap-

plication for permission to appeal a case previously decided in favor of the taxpayer. In this unitary business case, the intermediate appellate court held that capital gains resulting from a stock redemption transaction as part of a corporate reorganization were not taxable business earnings subject to apportionment. Applying the "unitary business principle," the court concluded that the taxpayer and its parent holding company were not unitary businesses under the "hallmarks of a unitary relationship" test (functional integration, centralized management, and economies of scale).

The taxpayer was an out-of-state limited partnership that produced, sold and distributed ice cream in Tennessee and elsewhere. In connection with a corporate reorganization, the taxpayer momentarily held stock of its holding company, which directly or indirectly owned the various interests that comprised the taxpayer, and the holding company then redeemed the stock. The taxpayer reported capital gains from the stock redemption transaction on its federal tax return. The Commissioner assessed excise tax on that transaction claiming that the gains were taxable "business earnings" subject to apportionment in Tennessee. The taxpayer challenged the assessment. The trial court held that there was no unitary relationship between the taxpayer and the holding company and, therefore, Tennessee's tax on the capital gains from the stock redemption transaction was unconstitutional under the unitary business principle.

On appeal, the Court of Appeals agreed that the taxpayer and its parent holding company were not unitary businesses. The Court of Appeals further held that the income from the stock redemption did not serve an "operational function" since those funds were distributed to the taxpayer's partners. Failing both constitutional tests under the unitary business principle, the court concluded that the excise tax assessment was unconstitutional.

The Tennessee Supreme Court granted the Commissioner's application for permission to appeal. The Supreme Court held oral argument and the case is under advisement.

> Several organizational changes were implemented within the Department of Revenue during former Commissioner Trost's term. Two new positions were created for an Assistant Commissioner for Compliance and Integrity and an Assistant Commissioner of Legal Affairs.

Tennessee Supreme Court Reverses Summary Judgment on Issue of Whether Use Tax Owed on Purchase of Airplane and Remands for Trial

CAO Holdings, Inc. v. Trost[33] is the second of two tax recent tax cases in which the Supreme Court granted a discretionary appeal at the request of the Commissioner. This case involved a use tax assessment on an airplane purchased outside the state, brought into Tennessee and leased to a related entity. Both the trial and appellate courts held, on cross-motions for summary judgment, that the taxpayer had purchased the plane for resale and, therefore, was not subject to Tennessee use tax. The Supreme Court reversed, holding that neither party was entitled to summary judgment as a matter of law, and remanded the case to the trial court.

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

The taxpayer was created to hold title to the airplane and insulate the sole shareholder from personal liability. The leasing entity was created to facilitate a time-sharing business for the use of the airplane by third parties. Under a non-exclusive lease agreement, the taxpayer rented the aircraft to the leasing entity, which was responsible for all operating costs. The lessee entered into time-share agreements with eight other entities, many of which were related to the individual owner of the taxpayer. The airplane's flight log listed the taxpayer as the operator, and the individual owner of the taxpayer was listed as the copilot on a majority of flights. The lessee invoiced the users of the airplane and, in turn, paid the taxpayer for the flight hours used.

The Department of Revenue received notice of the purchase of the aircraft and subsequently issued an

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assessment for use tax owed on the purchase price of the airplane, claiming that the aircraft was not purchased for resale, but primarily for the taxpayer's own use. About six months later, experiencing some buyer's remorse and disappointment with the results of the leasing arrangement, the taxpayer sold the airplane.

The taxpayer filed suit to challenge the assessment on the basis that the purchase of the aircraft and lease qualified as a sale for resale. The Department maintained that the airplane was not purchased for resale and further asserted that the lease between the taxpayer and the leasing entity was a sham. The parties filed cross-motions for summary judgment. Both the trial court and intermediate appellate court, in a 2-1 decision, held in favor of the taxpayer, based on their finding that the lease was sufficient to qualify as a purchase for resale.

The Supreme Court revisited the standards for summary judgment in Tennessee and concluded that those standards were not met by either party. The Court held that there are two criteria for a sale to qualify as a sale for resale: (1) the sale must have been made for the purposes of resale; and (2) the sale must be in strict compliance with the rules and regulations promulgated by the Commissioner, which rules require a lease of tangible personal property to "be used exclusively for renting or leasing" to qualify for the resale exemption. Although both parties argued that no material facts were in dispute, the Supreme Court disagreed and found that there was a genuine issue of disputed material fact on the exclusive use question that could not be decided on summary judgment. Further, the court held that there were disputed material facts on the issue of whether the lease was a sham, and remanded the case for trial.

Excise Tax on Interest Income Earned on Treasury Securities Held Unconstitutional

In *Siegel-Robert, Inc. v. Johnson*,[34] a case focusing on Tennessee's ability to tax income earned outside of Tennessee, the Court of Appeals held that the Department of Revenue's assessment of excise tax on interest earned by a multi-state taxpayer on funds invested in treasury securities was unconstitutional. Applying the "unitary business principle," the court found that the funds were used for investment purposes, not operational purposes, and the taxpayer's investment activities conducted outside the state were not unitary with its manufacturing activities in Tennessee.

This case squarely addressed the constitutional limits of Tennessee's power to reach outside its borders and require a multi-state taxpayer to apportion investment income earned outside the taxing state. The taxpayer had its headquarters and commercial domicile in St. Louis, Missouri. The taxpayer did business through several manufacturing divisions and subsidiaries, with its largest division engaged in automotive parts manufacturing in Tennessee and several other states. The taxpayer routinely invested excess cash in overnight repurchase agreements and included the interest earned on the repurchase agreements in its business earnings. However, when the taxpayer accumulated cash significantly in excess of its operational needs, it moved the excess funds to its investment portfolio where the funds were invested in treasury securities for periods ranging from one to four years. Only the interest earned on the treasury securities was at issue. When the treasury securities matured, the taxpayer either reinvested the funds into other treasury securities or used the proceeds to acquire other businesses to implement its long-term diversification strategy. All of the taxpayer's investment activities were conducted from its headquarters in Missouri and were held by financial institutions in St. Louis.

The taxpayer reported on its Tennessee return the interest earned on the treasury securities as nonbusiness earnings. The Department of Revenue disagreed and treated the interest as business earnings subject to apportionment for excise tax purposes for multiple tax years. The taxpayer challenged the assessments.

The trial court held in favor of the taxpayer on two grounds: (1) the interest income was "non-business earnings" for Tennessee excise tax purposes; and (2) the tax assessment was unconstitutional under the unitary business principle because there was no unitary relationship between the taxpayer and the payor of the interest income, the United States government, and the investments served an investment purpose, not an operational purpose. The Commissioner appealed.

The Court of Appeals agreed that the excise tax assessment was unconstitutional. Applying the analysis under the unitary business principle set forth in the U.S. Supreme Court decisions in *Allied-Signal, Inc. v. Director, Div. of Taxation*, and *MeadWestvaco Corp. v.*

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Illinois Dept. of Revenue, the Court stated that the relevant inquiry focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. Under the facts, it was obvious that there was no unitary relationship between the taxpayer and the payor of the income. Turning to the second test under the unitary business principle, the Court found that there was no unitary relationship between the taxpayer's out-of-state investment activities and its in-state manufacturing activities where the treasury securities served an investment purpose, not an operational one.

Unlike *Blue Bell Creameries*, the Commissioner did not seek discretionary review of the Court of Appeals' decision and the decision has now become final.

Dividend Income Taxable as "Business Earnings"

In yet another unitary business case – and reaching the opposite result from *Siegel-Robert* and *Blue Bell Creameries* – a trial court held in *H.J. Heinz Co. v. Chumley*[35] that dividends received by a taxpayer from its investment in an affiliated corporation's preferred stock were taxable business earnings subject to Tennessee franchise and excise tax. Applying the "unitary business principle" to the facts in this case, the trial court concluded that the taxpayer's business and that of its affiliate were unitary under the "hallmarks of a unitary relationship" test, and that the dividends constituted "business earnings" subject to Tennessee excise tax.

The taxpayer was a limited partnership that held interests in approximately 26 factories used in the food industry, one of which was located in Tennessee. Nationwide, the taxpayer employed over 8,000 employees, including those located in Tennessee. During the audit period, the Tennessee facility accounted for 2.34% of the taxpayer's property, 2.38% of the taxpayer's payroll, and 2.20% of its total sales. The majority owner of the taxpayer was H.J. Heinz, a Pennsylvania corporation, whose income during the audit period consisted of distributions from the taxpayer and various foreign food production affiliates, with a majority of income being received from the foreign affiliates. The taxpayer, through a single member limited liability company, held preferred stock of H.J. Heinz. The taxpayer asserted that the dividends received on the H.J. Heinz preferred stock were never used to fund the taxpayer's operations and, instead, were always deposited into an account with another affiliated company until distributed to its partners.

The Commissioner assessed excise tax on the dividend income received by the taxpayer claiming that the dividends were taxable "business earnings" of a multi-state "unitary business." The taxpayer challenged the assessment, asserting that dividend income was not subject to apportionment in Tennessee because the taxpayer was not a "unitary business" with its majority owner or foreign affiliates and, even if the entities were unitary, the dividends received by the taxpayer were nonbusiness earnings not subject to Tennessee excise tax. The trial court held that the business activities of the taxpayer and its affiliates, including H.J. Heinz as the payor of the dividends, were unitary businesses and that the dividends were properly characterized as business earnings for Tennessee excise tax purposes and subject to apportionment. The trial court also rejected the taxpayer's assertion that if it is required to include the dividends in its income subject to apportionment that the taxpayer also should include the property, payroll and sales of the foreign entities in the calculation of the taxpayer's apportionment formula.

The taxpayer appealed the trial court's decision. The Court of Appeals held oral argument and the case is under advisement.

Commissioner of Revenue's Authority to Alter the Standard Apportionment Formula Upheld

In *BellSouth Advertising & Pub. Corp. v. Chumley*,[36] a taxpayer lost its challenge to the Commissioner's authority to impose a variance to alter the standard apportionment formula for franchise and excise tax purposes under Tennessee's version of the Uniform Division of Income for Tax Purposes Act (UDITPA).

The taxpayer was engaged in the business of providing advertising services in connection with telephone directories distributed in Tennessee and other states. The parties stipulated that the taxpayer's sales of advertising services were "sales other than sales of tangible personal property." Under UDITPA, where a taxpayer's sales are other than sales of tangible personal property and the earnings producing activities are performed in multiple states, the sales are attributed or sourced to Tennessee only if a greater proportion of the earnings producing activities are performed in Tennessee than any other state based on costs of performance. Using the costs of performance analysis under UDITPA, the taxpayer

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sourced its sales outside Tennessee because its earnings producing activities were conducted outside the state, even though significant advertising revenues were generated within Tennessee.

Following an audit and notwithstanding the standard cost of performance analysis, the Commissioner imposed a variance using the authority granted under UDITPA, based upon the Commissioner's determination that the statutory formula did not fairly reflect the extent of the taxpayer's business activity in Tennessee, and issued a tax assessment of almost $9,900,000. The taxpayer sued and the trial court invalidated the variance, rejecting the Commissioner's position. The court found that the statutory cost of performance formula, which is presumed to be correct, was appropriate and the Commissioner failed to prove otherwise. The Commissioner appealed.

The intermediate appellate court reversed, after first noting that it had not previously addressed the issue of imposing a variance from the statutory costs of performance formula in connection with the sale of advertising. The appellate court found that the variance from the cost of performance formula was appropriate under the facts presented in order to fairly represent the extent of the taxpayer's business in the state, specifically relying on the facts that the taxpayer had paid only slightly less than $300,000 in Tennessee franchise and excise taxes but derived substantial advertising revenues of almost $900,000,000 from the distribution of nearly 24,000,000 telephone directories in Tennessee during the tax period.

The taxpayer requested permission to appeal to the Tennessee Supreme Court, but the application was denied and the Court of Appeals' decision is now final.

Two Related Limited Liability Companies Not an Affiliated Group for Purposes of Tennessee Franchise Tax

In *Valenti Mid-South Management, LLC v. Farr,* [37] the Court of Appeals considered the issue of whether two limited liability companies were an "affiliated group" for franchise tax purposes. The taxpayer management company was a limited liability company that operates a number of Wendy's restaurants in Tennessee. During the tax period, the taxpayer had a negative net worth for franchise tax purposes and was required to use the "property value" measure instead of the "net worth" measure in computing its franchise tax liability. By statute, property value is calculated using the actual value of real or personal property owned or used in Tennessee and includes a formula for the value of rented property. The management company leased all of the real property for the restaurants from a separate realty limited liability company that was also qualified to do business in Tennessee. Five individuals owned approximately 87% of both companies. The taxpayer management company did not include the value of the real property rented from the separate realty company, taking the position that the management and realty companies were an affiliated group for purposes of Tennessee's franchise tax laws based on the common ownership.

Tennessee generally is a separate reporting state for purposes of determining franchise tax liability. However, since 2004, a taxpayer that qualifies as a member of an "affiliated group," as that term is defined by statute, "may elect to compute its net worth on a consolidated basis."[38] The Department of Revenue assessed additional franchise tax based on its conclusion that the limited liability companies did not qualify as an affiliated group and, further, that the consolidated reporting statute only permits consolidation of net worth and not consolidation of property value.

The trial court held that the management company and the realty company did not qualify under the statute as an affiliated group and, even if they did, they could not utilize the consolidated computation for the property value measure of the franchise tax base. The trial court rejected the taxpayer's argument that the assessment resulted in double taxation.

The Court of Appeals affirmed solely on the basis that the limited liability companies did not meet the definition of an affiliated group and did not reach the secondary issue of whether the consolidated reporting statute permits consolidation of property value for purposes of calculating the franchise tax base.

Dry-Cleaning Services Provided to Formalwear Business Not "Sales for Resale"

In *Walker's, Inc. v. Farr,* [39] the Court of Appeals recently held that dry cleaning and laundering services provided by a taxpayer to a formalwear business that rents and sells tuxedos are not sales for resale

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under Tennessee's Retailers' Sales Tax Act. The court found that the services provided did not amount to "processing" as required under the Department of Revenue's rules and regulations governing sales for resale, and concluded that the sales did not fall within the "sale for resale" exemption.

The trial court had held in favor of the taxpayer, finding that the laundering and dry cleaning services "constituted a necessary 'process' in the formalwear rental and sales business" conducted by the taxpayer's customer, and concluded that the services were "sales for resale." Interestingly, between the trial court's ruling and the decision by the Court of Appeals, the Tennessee General Assembly passed the administration's annual Technical Corrections Bill, which included a section amending the "sale for resale" provision to clarify that it does not include the "sale of services to a dealer for use in the business of selling, leasing or renting tangible personal property. . . ."[40] The Court of Appeals rejected the taxpayer's "processing" argument, finding that dry cleaning and laundering services did not "result in a change of state or form" of the formalwear. Although the Retailers' Sales Tax Act does not contain a definition of the term "processing" for purposes of the sale for resale exemption, the Court of Appeals followed the analysis supplied in an earlier decision by the Tennessee Supreme Court in *Beare Co. v. Tennessee Dep't of Revenue*,[41] to conclude that cleaning services are not "processing" within the meaning of the sales tax statutes. The Court also rejected the taxpayer's argument that its services were sales of "packaging materials" and excluded from the definition of sale at retail, finding that the object of the services provided was not the furnishing of packaging materials.

The taxpayer has filed an application for permission to appeal that is pending.

Security Monitoring Equipment Not a "Sale for Resale" and Subject to Use Tax; Taxpayer Waived Defense of Equitable Recoupment

In another sale for resale case, *ADT Security Services, Inc. v. Johnson*,[42] a use tax assessment was upheld on security monitoring equipment purchased by a taxpayer and used in connection with providing security and monitoring services to its customers. The taxpayer purchased security monitoring equipment used in providing its services without paying sales tax on the equipment claiming that it was purchased for resale to its customers as leased equipment. Upon installation of the equipment, the taxpayer charged its customers a one-time, non-itemized installation fee on which the taxpayer collected and remitted sales tax to the Department of Revenue. The Department assessed use tax on the security monitoring equipment, claiming that the taxpayer used the equipment to provide security services to its customers and, therefore, did not purchase the equipment for resale. The taxpayer challenged the assessment.

At trial, the taxpayer argued that the 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 the taxpayer charged separately for the lease and installation of the equipment. In closing argument, the taxpayer asserted—for the first time—that even if the court found that use tax was owed on the equipment, the taxpayer 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 argued that the taxpayer failed to prove that it leased the monitoring equipment to its customers, and the evidence instead proved that ADT installed and used the monitoring equipment in the fulfillment of its security services contracts.

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

On appeal, the court affirmed the trial court's decision in part and reversed it in part, with both holdings in favor of the Commissioner. The court upheld the use tax liability, but reversed the ruling as to the taxpayer's entitlement to equitable recoupment 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 the taxpayer did not raise that affirmative defense until closing argument, after the close of proof, the taxpayer was deemed to have waived it.

The Tennessee Supreme Court denied the taxpayer's application for permission to appeal, and the Court of Appeals' decision is now final.

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Glucometers Not Exempt from Sales and Use Tax as "Prosthetics"

The taxpayer in *Maxwell Medical, Inc. v. Chumley*[43] sold glucometers and related products used to monitor and measure glucose functioning in the body. The taxpayer sought a tax refund on sales tax previously paid claiming the products were exempt from sales tax as prosthetics because they replaced the normal function of the pancreas in monitoring blood glucose levels. The Court of Appeals disagreed, finding that the glucometers only measured the levels of blood glucose and did not regulate or control those levels. Because the glucometers do not replace or substitute for the function of the human pancreas, the exemption did not apply.

Rail Carrier Seeks Relief in Federal Court Alleging Discriminatory State Taxation on Diesel Fuel

In another potential landmark case, *Illinois Central Railroad Co. v. Tennessee,*[44] a railroad company has sued the Department of Revenue in federal district court, seeking to enjoin the Department from assessing Tennessee sales and use tax on the railroad company's purchase or consumption of diesel fuel for rail transportation purposes. The company claims that such tax violates Section 306 of the Railroad Revitalization and Regulatory Reform Act of 1976,[45] which provides that it is unlawful for a state to impose any tax resulting in discriminatory treatment of a common carrier by railroad. The company maintains that because no similar tax is imposed on the purchase or consumption of diesel fuel purchased by motor carriers for transportation purposes, the imposition of the tax on rail carriers is discriminatory.

The case has been stayed pending the decision by the U.S. Supreme Court in *CSX Transportation, Inc. v. Alabama*.[46]

Court of Appeals Rules TNInvestco Documents Are Protected "Tax Information" and "Tax Administration Information" Not Subject to the Public Records Act

In 2009, Tennessee enacted the Tennessee Small Business Investment Company Credit Act, referred to as the TNInvestco Act.[47] This Act is designed as an economic incentive and job creation program, where the state allocated up to $120 million in tax credits to qualified TNInvestco companies. In turn, the selected TNInvestco companies sell the tax credits to participating insurance companies that are Tennessee taxpayers to offset their Tennessee tax liability, which generates capital for the TNInvestco companies for investment purposes. The Commissioner of Economic and Community Development and the Commissioner of Revenue were authorized, within their sole discretion, to select six qualified TNInvestco companies.

Twenty-five entities applied to qualify as TNInvestco companies. One applicant among those not selected, made several public records requests under the Tennessee Public Records Act[48] seeking information about the selection process used by the Commissioners. The Commissioners denied the requests on three grounds, asserting: (1) that the information was confidential "tax information" or "tax administration information" pursuant to Tenn. Code Ann. § 67-1-1702; (2) that the information was confidential pursuant to Tenn. Code Ann. § 4-3-730(c), having been designated as records the disclosure of which would be harmful to the state's ability to compete for economic and community development contracts; and (3) the evaluation information was protected by the "Deliberative Process Privilege."

The applicant filed a lawsuit in *Coleman v. Kisber*[49] to challenge the Commissioners' refusal to make the information public. The trial court held that the documents were within the protection of Tenn. Code Ann. § 4-3-730, as sensitive economic development information and rejected the other grounds asserted by the Commissioners. The Court of Appeals reached the same result but on different grounds. The Court of Appeals held that the statutory protection afforded to "tax information" and "tax administration information" applied and the information was therefore protected from disclosure on that basis.

The plaintiff has filed an application for permission to appeal to the Tennessee Supreme Court, which is pending.

Administrative Highlights from 2010

2010 Administrative Notices

The Department of Revenue took limited action on the administrative front. Two administrative notices are highlighted as follows:

Flood Relief

Following the devastating floods that occurred in Middle Tennessee in early May 2010, the Department issued Notice 10-01, providing taxpayers with information about tax relief that was available for flood victims. Individuals who received assistance from the Federal Emergency Management Agency (FEMA) as a result of the flooding were eligible to request refunds of Tennessee sales tax paid on certain items purchased to replace damaged or destroyed items, such as appliances, residential furniture, and residential building supplies.

Offset of State Tax Refund Claims

Another administrative action included the issuance of Notice 10-02, informing taxpayers that a new "Report of Debts" form must be submitted with any claim for refund for $200 or more. In addition, taxpayers that filed a claim for refund with the Department for $200 or more after July 1, 2009 must also complete and submit a Report of Debts if the refund has not yet been paid. This notice was issued following the enactment of new statutory provisions, see the discussion above, directing the Department of Revenue to offset refunds by the amount of any debt owed by the taxpayer to a state agency, department, board, bureau, commission or authority.[50]

New Commissioner Appointed to the Tennessee Department of Revenue

Tennessee Governor Bill Haslam, who was sworn into office on January 15, 2011, has appointed Richard Roberts as the new Commissioner of Revenue for the State of Tennesseee. Commissioner Roberts replaces Charles A. Trost, who previously was appointed by former Governor Phil Bredesen to serve as Commissioner of Revenue following the resignation of former Commissioner Reagan Farr on September 1, 2010 to return to the private sector.

Commissioner Roberts is an attorney and business executive from East Tennessee. Roberts has been a director of Miller Industries, Inc. and previously served as an officer and general counsel with Forward Air Corporation and Landair Corporation. He is a graduate of the University of Tennessee Knoxville and has a joint J.D./M.B.A degree from the University of Tennessee College of Law.

Several organizational changes were implemented within the Department of Revenue during former Commissioner Trost's term. Two new positions were created for an Assistant Commissioner for Compliance and Integrity and an Assistant Commissioner of Legal Affairs.[51]

Endnotes

1 2010 Tenn. Pub. Acts, Ch. 1134.
2 Tenn. Code Ann. §67-4-2004(7).
3 Tenn. Code Ann. §67-4-2004(8).
4 Tenn. Code Ann. §67-4-2006(a)(9).
5 Tenn. Code Ann. §67-4-2006(b)(3). The insertion of the amendment as Tenn. Code Ann. §67-4-2006(b)(3) appears to be an error and, instead, the amendment should have been inserted as Tenn. Code Ann. §67-4-2006(b)(1)(O).
6 Tenn. Code Ann. §67-4-2013(d).
7 *Id.*
8 Tenn. Code Ann. §67-4-2106(b).
9 *Id.*
10 *See* Tenn. Code Ann. §§67-4-2111.
11 Tenn. Code Ann. §67-4-2114(d).
12 *Id.*
13 Tenn. Code Ann. §67-4-2109(o).
14 Tenn. Code Ann. §67-4-2004(31).
15 Tenn. Code Ann. §67-4-2004(41).
16 Tenn. Code Ann. §67-4-2109(p).
17 *Id.*
18 Tenn. Code Ann. §67-4-2109(h)(10).
19 Tenn. Code Ann. §67-4-2109(b)(3)(J).
20 Tenn. Code Ann. §§67-4-2109(b)(3)(I), (h)(9).
21 Tenn. Code Ann. §67-4-2109(k).
22 Tenn. Code Ann. §67-6-346.
23 Tenn. Code Ann. §67-5-604(d).
24 Tenn. Code Ann. §67-4-2108(a)(5)(C).
25 Tenn. Code Ann. §67-4-2109(b)(2)(B)(iii).
26 Tenn. Code Ann. §67-6-102(47)(H)(i)(*c*).
27 Tenn. Code Ann. §67-4-2009(10).

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