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SHOP TALK

Tennessee's Unprecedented Approach in Attacking Affiliated Intangible Holding Companies

The editors of The Journal of Multistate Taxation and Incentives feature this column as a forum for discussing important multistate tax issues. We invite letters from our readers, either commenting on articles or columns in The Journal or sharing ideas and experiences with other readers. Letters should be addressed to Mark Wolowitz, Managing Editor, The Journal of Multistate Taxation and Incentives, Thomson Reuters, 1 New York Plaza, 34th Floor, New York, New York 10004. This article appears in and is reproduced with the permission of the Journal of Multistate Taxation and Incentives, Vol. 22, No. 4, July 2012. Published by Warren, Gorham & Lamont, an imprint of Thomson Reuters.

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Tennessee gets tough on related-company expenses. Multistate taxpayers are all-too-familiar with intangible expense add-back statutes, which have become one of the most common ways that state taxing authorities can attack intangible expenses paid to affiliates. (For a detailed discussion of this area, see, e.g., Weinstein and Santoro, "Related-Party Expense Addbacks: History, Trends, and Developments," 20 J. Multistate Tax'n 6 (August 2010).)

In recent years, Tennessee has been scrutinizing the intangible expenses that companies pay to their affiliates. The state ramped up its attack on these transactions during the most-recent legislative session with the enactment of S.B. 2234, 4/27/12 (2012 Tenn. Pub. Law No. 842), §§1-5, applicable to all tax years ending after June 2012.

Unlike other states that generally require a taxpayer to add back certain intangible expenses paid to affiliates but leave it to the taxpayer to comply with the add-back requirement, Tennessee, under the new law, will not allow a taxpayer to deduct an intangible expense paid to an affiliate unless the taxpayer files an application with the

state's Department of Revenue, seeking advance approval for the deduction from the Commissioner of Revenue.

What is an intangible expense? Under Tenn. Code Ann. §67-4-2004(23), an "intangible expense" is "an expense related to, or in connection with, the acquisition, use, maintenance, management, ownership, sale, exchange, license, or any other disposition of intangible property, to the extent such amounts are allowed or allowable as deductions or costs in determining federal taxable income...." The new law clarifies that intangible expenses also specifically include "interest expenses directly or indirectly allowed as deductions or costs in determining federal taxable income on a separate entity basis to the extent such interest expenses are directly or indirectly for, related to, or in connection with the direct or indirect acquisition, use, maintenance, management, ownership, sale, exchange, license, or any other disposition of intangible property" (§67-4-2004(23), as amended by Pub. Law No. 842, §1).

Background. In determining net income or loss for purposes of the Tennessee excise tax, a corporation starts with federal taxable income or loss. For state tax purposes, one adjustment to federal income is to add back "[a]ny otherwise deductible intangible expense paid, accrued or incurred in connection with a transaction with one or more affiliates" (Tenn. Code Ann. §67-4-2006(b)(1)(K)). Under the law in effect prior to July 2012, the taxpayer then could deduct "[a]ny intangible expense paid, accrued or incurred in connection with a transaction with one (1) or more affiliates that has been disclosed in accordance with subdivision (d)(1)" (Tenn. Code Ann. §67-4-2006(b)(2)(N), applicable to tax years ending before July 2012).

Audits and assessments. The new law follows on the heels of the Department's audit, assessment, and settlement with taxpayers that had complied with the former requirement to disclose intangible expenses paid to affiliates. Assessments were made against numerous taxpayers pursuant to the Department's "variance" power to deny deductions based on the premise that the intangible expenses were not paid pursuant to a transaction with a valid business purpose and that the transactions lacked economic substance. Following administrative challenges to these assessments, taxpayers entered into negotiations with

the Department to construct a global compromise for open tax periods ending before July 2012.

Compromise opportunity. In Tenn. Important Notice (Excise Tax) No. 11-17, 11/1/11 ("Compromise Potential for Intangible Expenses"), the Department extended this opportunity to compromise tax liabilities for any period ending before July 2012 to other taxpayers that had not been audited but voluntarily came forward. Pursuant to this Notice, many other taxpayers that had made intangible expense payments to affiliates approached the Department voluntarily, taking advantage of the compromise. The compromise is ostensibly still available for taxpayers that have not been audited and have not yet voluntarily approached the Department. The window on this compromise may be closing, however.

The new legislation. The new law requires taxpayers to file an application with the Department for advance approval to deduct intangible expenses paid to affiliates. The Commissioner's consideration of the application will be to determine whether the expense has "as its principal purpose the avoidance of the [Tennessee excise] tax...." (Tenn. Code Ann. §67-4-2006(b)(2)(N), as amended by Pub. Law No. 842, §2.) Review of the application will include consideration of federal taxation concepts to determine whether there are "arm's-length" dealings and whether the transaction has a "business purpose" or, instead, was entered into with the primary purpose of avoiding excise tax. Taxpayers can look for guidance in published rulings, including Tenn. Ltr. Ruls. 06-28 (7/20/06) and 06-35 (9/22/06).

Three exceptions guarantee approval. There are three exceptions that, if applicable, would *require* the Commissioner to approve an application for the deduction of an intangible expense or portion thereof that was paid, accrued, or incurred to an affiliate.

(1) *Foreign tax treaty exception.* The affiliate is "in a foreign nation that is a signatory to a comprehensive income tax treaty with the United States."

(2) *Conduit exception.* During the same tax year, the affiliate has directly or indirectly paid, accrued, or incurred the intangible expense to an entity that is not an affiliate.

(3) *Subject-to-tax exception.* The affiliate is doing business in, or deriving income from, a state that imposes a net-income-based tax and, under that state's laws, the affiliate is subject to such income tax in that state. The portion of the intangible expense that will be approved for deduction is the portion that, after applying the allocation and apportionment rules of the state, has been allocated or apportioned by the affiliate to that taxing state. For this purpose, "state" means any U.S. state, including the District of Columbia, and any U.S. possession or territory. This exception does not apply, however, to a state under whose laws the taxpayer and the affiliate file or are included in a combined or consolidated tax return that results in the affiliate's intangible income being offset or matched by the taxpayer's deduction in that return.

(Tenn. Code Ann. §§67-4-2006(b)(2)(N)(i)(a), (b), and (c), as added by Pub. Law No. 842, §2.)

Filing the application; disputing a denial. Applications generally must be filed 60 days prior to the due date of a return in order for the taxpayer to avoid penalties. A taxpayer whose deduction is based on any of the three exceptions listed above, however, may provide notice to the Commissioner at the time of filing its return, rather than by complying with the 60-day requirement. (Tenn. Code Ann. §§67-4-2006(b)(2)(N)(ii) and (iii), as added by Pub. Law No. 842, §2.)

A taxpayer may challenge the Commissioner's denial of an application by claiming the deduction and contesting the Department's assessment of tax, interest, and penalty in court. (Tenn. Code Ann. §§67-4-2006(b)(2)(N)(ii) and (iii), 67-4-2006(d), and 67-1-804(b)(2), as added/amended by, respectively, Pub. Law No. 842, §§2, 4, and 5.)

What's next? The options available for taxpayers depends on whether or not the taxpayer took advantage of the compromise opportunity discussed above.

Taxpayers that agreed to the compromise. Taxpayers that have entered into the compromise will still have the option of filing an application with the Commissioner to seek approval of the deduction for future periods. In the alternative, those taxpayers can choose not to claim the deduction.

Taxpayers that have not sought to compromise. Taxpayers that have paid intangible expenses to affiliates but have not voluntarily approached the Department must decide whether to seek protection under the compromise, for tax periods ending before July 2012. Those taxpayers will not be permitted to deduct intangible expenses paid to affiliates for years ending after June 2012, unless the taxpayer files an application with the Department to seek advance approval to take the deduction. To the extent that this latter approach is taken and the Department denies the application, the taxpayer's prior tax periods also may be at risk of an audit and assessment. If the Department audits a taxpayer's prior years, the taxpayer may no longer be able to take advantage of the terms of the initial compromise offer. Taxpayers in this situation also could choose not to file the application and not claim the deduction for future periods if the taxpayer believes that the application will not be approved. Those taxpayers will nevertheless be at risk of audit for open periods.

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