

PUBLICATION

Spotlight on Tennessee: R&D Exemption for Sales/Use Taxes

Authors: Carl E. Hartley

July 14, 2016

This State's industrial machinery exemption for sales and use tax purposes offers a significant benefit to manufacturers in Tennessee. With a general State tax rate of 7%, together with the added local tax rates, substantial savings can be realized through the use of this exemption.

This important exemption was expanded during the 2015 Legislative Session to include "research and development." Through proposed regulations which are intended to be effective September 26, 2016, the Tennessee Department of Revenue ("Department") is providing guidance as to the use of this R&D exemption – such as declaring that application of the R&D exemption is not just limited to manufacturers.

I. 2015 Statutory Exemption for R&D

The industrial machinery exemption, found at Tenn. Code Ann. § 67-6-206, states in part that "no tax is due with respect to industrial machinery." Pursuant to Section 17 of 2015 Public Chapter 504, effective July 1, 2015, the definition of industrial machinery currently found at Tenn. Code Ann. § 67-6-102(44) was expanded to provide:

"'Industrial machinery' also includes machinery, apparatus, and equipment with all associated parts, appurtenances, and accessories, including hydraulic fluids, lubricating oils, and grease necessary for operation and maintenance, repair parts, and any necessary repair or taxable installation labor therefor, that is necessary to, and primarily for, the purpose of research and development...."

This statutory expansion to include a sales/use tax exemption for R&D, as invaluable as it is, did not address a number of issues. Just for example, which taxpayers can apply for the R&D exemption, how will the Department construe the term "research and development" for purposes of this exemption, and by what method is the exemption applied for and approved by the Department? These and other issues are addressed by the Department in proposed regulations filed earlier this year with the Tennessee Secretary of State.

II. New Rule 128, Research and Development

On February 25, 2016, the Department filed proposed regulations with the Secretary of State which cover a wide variety of procedural and substantive Tennessee tax topics. According to information from the Secretary of State, the final version of these proposed regulations from the Department will be effective September 26, 2016.

Among those proposed regulations is new Sales and Use Tax Rule 1320-05-01-.128 ("Rule 128") which, when effective, is intended to provide more information regarding the application and administration of the R&D exemption.

A. Who Can Benefit from the R&D Exemption? Subsection (6) of new Rule 128 provides that "(p)ersons are not required to be engaged in any business of fabricating and processing tangible personal property for resale" in order to qualify for the R&D exemption. Thus, taxpayers that are not "manufacturers" – and as such would

not qualify for the general industrial machinery exemption – are nevertheless allowed to apply for the R&D exemption.

B. What Constitutes R&D? Subsection (2)(a) of new Rule 128 provides that R&D "must have one of the following as its ultimate goal:"

1. basic research in a scientific field of endeavor;
2. advancing knowledge or technology in a scientific or technical field of endeavor;
3. the development of a new product, whether or not the new product is offered for sale;
4. the improvement of an existing product, whether or not the improved product is offered for sale;
5. the development of new uses of an existing product, whether or not a new use is offered as a rationale to purchase the product; or
6. the design and development of prototypes, whether or not a resulting product is offered for sale.

Future rulings, notices and other publications from the Department may offer further insights into the Department's interpretation of one or more of these acceptable R&D goals.

C. What Does Not Constitute R&D? Subsection (2)(b) provides that R&D "does not include:"

7. ordinary testing or inspection of materials or products used for quality control, other than that occurring during the activities listed in subsection (2)(a) of this rule;
8. market research;
9. efficiency surveys;
10. consumer surveys;
11. advertising and promotions;
12. management studies; or
13. research in connection with literary, historical, social science, psychological or other similar nontechnical activities.

Future publications from the Department may also assist in better understanding those situations in which a R&D exemption certificate will not be issued because of the foregoing activities.

D. How to Apply for the R&D Exemption? Subsections (3) through (5) of new Rule 128 provide insight as to the application process as well as related topics. For instance, Subsection (3) provides that application shall be made to the Department for authority to make R&D purchases exempt from the tax; and further provides that, "the application shall give such information" as the Department may require. The Department has advised that the form of such application will not be the same as the current Application For Industrial Machinery Exemption used to obtain the general industrial machinery exemption. Rather, a new specific form applicable only to R&D purchases is being prepared by the Department and will be published on the Department's website at some point in the future.

Further, Subsection (4) provides that the R&D exemption authorization "must be obtained prior to making such purchases exempt from the tax." That Subsection goes on to state that if authority is not obtained prior to the purchase, Department may allow retroactive application upon a showing that the failure to obtain the authority resulted from: (a) a major restructuring of the business or the business having gone through a change in ownership; or (b) a death of a key person in the tax area of the organization; or (c) the entity having been misled by State officials which indicated that the authority to purchase R&D machinery was not required; or (d) any other ground that the Department finds satisfactory to allow a retroactive application of the exemption. Since the specific application form for the R&D exemption is not yet published, but nevertheless the statutory exemption has been in effect since July 1, 2015, the unavailability of such specific form would hopefully

constitute "other grounds" upon which the Department will allow the exemption to be issued retroactively for purchases from and after July 1, 2015 – assuming all other conditions for the R&D exemption are satisfied.

Once the R&D exemption has been authorized by the Department, Subsection (5) provides that vendors shall be provided with a copy of the tax exemption authorization issued by the Department or a fully completed Streamlined Sales Tax Certificate of Exemption which must include the R&D exemption authorization number on the certificate issued by the Department.

E. Other R&D Exemption Matters. The Department could certainly raise questions upon reviewing a R&D application as to whether certain items of machinery, apparatus or equipment, etc. (as stated within Section 17 of 2015 Public Chapter 504) constitute or do not constitute exempt R&D; and, as a result, the new application form should be completed as fully as possible in describing the ultimate goals of the desired items consistent with Subsection (2)(a) of new Rule 128.

Separately, and from discussions with the Department, the new R&D application form (when published) will clarify that if a taxpayer holds an authorization to purchase R&D exempt from the tax, then the taxpayer can also seek a direct pay permit under Rule 1320-5-1-.68(4); and, if such a direct pay permit is issued, then the taxpayer can give its vendors either a copy of the R&D authorization or a copy of the direct pay permit authorization – accomplishing essentially the same result.

III. Summary

Tennessee's R&D tax exemption for sales and use tax purposes is an invaluable addition to the tax incentives otherwise available in this State for businesses. However, as noted above, there are a number of conditions that must be fulfilled in order to obtain such exemption. Your particular facts and circumstances must be carefully considered as you analyze whether those conditions can be satisfied by your business.

Please contact the author of this alert, Carl E. Hartley, or any other attorney within the Firm's Tax Group, should you have any questions or otherwise wish to discuss this R&D exemption or any other Tennessee tax related initiatives.