

PUBLICATION

Spotlight on Tennessee: Proposed Revenue Modernization Act

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Governor Haslam's Administration has very recently proposed far-reaching amendments to Tennessee's tax laws. These proposed amendments are included in Senate Bill 603/House Bill 644, known as the Revenue Modernization Act (RMA). The RMA, if enacted, would amend Tennessee's business tax, excise and franchise taxes, as well as sales and use taxes. While the full impact of the RMA is still being studied, the following is a preliminary summary of and some comments regarding certain Sections within the RMA:

Section 2 (Amends Business Tax). RMA Section 2 would add a new definition within Tennessee Code Annotated (TCA), Section 67-4-702(a) — that is, "substantial nexus in this state." The definition of "substantial nexus in this state" would include not only traditional notions of nexus such as being organized or domiciled in Tennessee or systematically and continuously doing business activity in Tennessee, but also would include economic presence as constituting substantial nexus if the business has either a certain amount of total receipts, a certain amount of property or a certain amount of paid compensation in Tennessee. This proposed definitional provision would expand the reach of the tax to more out-of-state businesses.

Section 3 (Amends Business Tax). RMA Section 3 would amend TCA Section 67-4-711(a)(6) which currently provides a deduction from the business tax for sales of services substantially performed in other states. In place of that current language, the RMA would provide a deduction for services that are "delivered to a location outside this state." This proposed provision may have the effect of reducing deductions if part of the service is not delivered out-of-state.

Section 4 (Amends Business Tax). RMA Section 4 expands the scope of business activities subject to the tax. Under current TCA Section 67-4-717, out-of-state companies without a physical location in Tennessee are subject to the business tax if they are performing any one of the four activities specifically enumerated in that Section. Under Section 4 of the RMA, however, all persons with "substantial nexus in this state" (see paragraph A above) and "engaged in this state" in any vocation, occupation, business or business activity with or without establishing a physical location in Tennessee are subject to the tax. The phrase "engaged in this state" includes, but is not limited to, various enumerated activities. In particular as to out-of-state businesses having no location in Tennessee, the intent of this RMA Section 4 is to shift from a narrow standard that is focused upon the four enumerated activities that are currently taxable to a broad standard that references certain identified activities as including but not being limited to the type of activities that would be taxable. As a result, and consistent with RMA Section 2, more businesses may become subject to the tax under this proposed amendment.

Section 5 (Amends Excise Tax). Essentially the same "substantial nexus in this state" standard, as proposed for the business tax, would be adopted by this RMA Section 5 for the excise tax by amending TCA Section 67-4-2004. Similarly, for excise tax substantial nexus purposes the RMA would include not only traditional notions of nexus such as being organized or domiciled in Tennessee or systematically and continuously doing business activity in Tennessee, but also would include certain economic presence in this state as constituting substantial nexus. RMA Section 5 would impose the excise tax on a wider spectrum of out-of-state businesses.

Section 6 (Amends Excise Tax). TCA Section 67-4-2006(b)(2) currently provides for a deduction from the excise tax with respect to intangible expenses paid to an affiliate if the intangible expenses have been approved in advance for deduction by the Commissioner, with certain safe harbors that require the Commissioner's approval (such as the intangible expenses paid to a foreign affiliate, expenses paid to an affiliate where the affiliate pays the same amount to a non-affiliate, and expenses paid to an affiliate which is taxed on those payments in another state). RMA Section 6 provides that if the taxpayer disputes the Commissioner's determination as to such application, the burden shall be on the taxpayer to show by "clear and convincing evidence" that the Commissioner's determination is incorrect. That RMA Section 6 also provides that the transaction giving rise to the intangible expense (or portion thereof) must have a "substantial business purpose" in addition to the current standard of not having "as its principal purpose the avoidance of the tax." Definitions for the foregoing phrases are not included in the RMA, so an effect of this RMA Section 6 may well be to increase the difficulty of the application process.

Section 8 (Amends Excise Tax). RMA Section 8 deletes the current apportionment provisions dealing with the sale of "other than tangible personal property" (that is, the sale of services or intangibles) currently found at TCA Sections 67-4-2012 (i) and (j), where at least the former is premised upon performance of the earnings-producing activity. Those two statutory Sections would be replaced with one consolidated provision that essentially establishes that the receipts from the sale of property other than tangible personal property is in Tennessee "if the taxpayer's market for the sale" is in Tennessee. RMA Section 8 states (among other situations) that the market for a sale is in Tennessee if the property is located in Tennessee, or if the service is delivered in Tennessee, or if the intangible property is leased or licensed and then to the extent the property is used in Tennessee (with certain provisos), or if the intangible property is sold and then to the extent the property is used in Tennessee with certain additional conditions for licensed geographic areas and situations where receipts from intangible property are contingent upon productivity. Where a determination cannot be made as to which state should be assigned the receipts from the sale of other than tangible personal property based upon the foregoing, RMA Section 8 provides that the state of assignment "shall be reasonably approximated;" and where the state of assignment cannot be reasonably approximated, then the sale shall be excluded from both the numerator and denominator of the sales factor. The RMA's proposal to shift from earnings-producing performance sourcing to a market-based sourcing is a significant step and may have profound implications for many businesses.

Section 9 (Amends Excise and Franchise Taxes). RMA Section 9 would adopt a new elective apportionment provision for certain taxpayers having significant sales of tangible personal property in Tennessee which constitute "certified distribution sales." The phrase "certified distribution sales" means the sale of tangible personal property "in this state by the taxpayer to a distributor" that are resold for use and consumption outside of Tennessee provided that the distributor certifies that such property has been resold for use and consumption outside the state. Assuming that the taxpayer makes an election under this new provision, "the total amount derived from certified distribution sales shall be excluded from the numerator of the receipts factor" — in essence, not attributing to Tennessee any such sales to a distributor where the distributor in turn sells those goods outside of Tennessee, thus reducing the overall amount that is being apportioned to Tennessee under the three factor formula. In exchange for such exclusion, the taxpayer must pay a separate excise tax on the certified distribution sales equal to 0.5% if such sales do not exceed \$2 billion; 0.375% of such sales that exceed \$2 billion but not more than \$3 billion, plus a payment of \$10 million; 0.25% of such sales that exceed \$3 billion but not more than \$4 billion plus an additional \$13 3/4 million; and 0.125% of such sales that exceed \$4 billion plus an added \$16 1/4 million. This separate excise tax is in addition to the existing excise tax. A taxpayer would be able to utilize this alternative, elective apportionment if its gross sales of tangible personal property in Tennessee exceed \$1 billion and the taxpayer's receipts factor exceeds 10%. This RMA Section 9 would seem to encourage, through the interaction of high volume sellers of tangible personal property, the potential location of distributors in Tennessee.

Section 11 (Amends Franchise Tax). RMA Section 11 would amend the franchise tax in a manner similar to RMA Section 8 with respect to the excise tax.

Section 12 (Amends Sales/Use Taxes). RMA Section 12 would add a new definition within TCA Section 67-6-102 of the sales and use tax laws for "video game digital product" — which means the right to access and use computer software that facilitates human interaction with a user interface to generate visual feedback for amusement purposes where the computer software is maintained by the seller or third party, regardless of whether the charge for the service is on a per use, subscription or other basis. RMA Section 14 would then include that new definition of "video game digital product" with the current "specific digital products" as being taxable in Tennessee under TCA Section 67-6-233.

Section 13 (Amends Sales/Use Taxes). RMA Section 13 would amend Section 67-6-231(a) so as to establish a new subdivision providing that the use of computer software includes the right to access and use software that remains in the possession of a dealer who provides the software or in the possession of a third party on behalf of such dealer. The RMA further states that if the customer accesses the software from a location in Tennessee, as indicated by the residential street address or the primary business address of the customer, such access shall be deemed equivalent to the sale or licensing of the software and electronic delivery of the software "for use in this state." The proposed language which also provides that the dealer may allocate to Tennessee a percentage of the sales price where such price relates to users both in and outside Tennessee. RMA Section 13 also states that nothing in this new subdivision shall be construed to impose a tax on any services that are not subject to tax under the sales and use tax laws, such as information services, payment processing services, internet access, mere storage of digital products, among others. Even with the foregoing services remaining non-taxable, RMA Section 13 may very well expand the types of computer software services subject to the tax especially where the server is maintained outside Tennessee.

Section 15 (Amends Sales Tax). RMA Section 15 adds a new statutory Section to the sales and use tax laws which would provide that it is the legislative intent to impose the sales and use taxes "to the fullest extent" allowed by the U.S. and Tennessee constitutions.

Section 16 (Amends Sales/Use Taxes). RMA Section 16 would add "click-through" nexus provisions that have been adopted in certain other states. This new provision provides that a dealer is presumed to have a representative, agent or salesperson in Tennessee making sales and "is presumed to have substantial nexus" in Tennessee if the dealer enters into a contract under which persons, for commission or other consideration, directly or indirectly refer potential customers to the dealer "whether by a link or an Internet website or by other means," and the dealer's cumulative gross from retail sales through all such persons in Tennessee exceed \$10,000 in the preceding 12-month period. This presumption of substantial nexus "may be rebutted only by clear and convincing evidence" (which again is a phrase not defined in the RMA) that the person with whom the dealer has the agreement did not conduct any activities in Tennessee that would substantially contribute to the dealer's ability to establish and maintain a market in the state.

Section 18 (Effective Date). Under RMA Section 18, amendments to the business tax and to the excise/franchise taxes would take effect January 1, 2016 and apply to all tax years beginning on or after January 1, 2016; and the sales and use tax amendments would take effect on July 1, 2015.

The Legislative Session has just begun and it is too early to anticipate whether or not the RMA in its current text or otherwise will be enacted. However, it is evident that the current Administration is focused upon expanding the tax base in Tennessee. As a result, taxpayers should pay close attention to the pertinent legislative deliberations pertaining to the RMA, as well as pertaining to other tax related bills, as this Session moves forward.

Please do not hesitate to contact attorneys in this Firm's Tax Group should you have any questions or otherwise wish to discuss the RMA or other tax bills in the Tennessee Legislature.