

## Tennessee Enacts Broad Changes to State's Tax Code

May 28, 2015

### Overview

Tennessee Governor Haslam recently signed into law the Revenue Modernization Act (the "Act") (H.B. 0644).<sup>1</sup> The Act includes the following modifications to Tennessee law:

- Adopts economic nexus thresholds for the business tax and the franchise and excise tax
- Replaces the existing apportionment double-weighted sales factor with a triple-weighted sales factor for calculating the franchise and excise tax
- Amends the excise tax deduction for intangible expenses paid to an affiliate
- Adopts market-based sourcing for sales other than the sale of tangible personal property
- Adds an elective apportionment calculation for high-volume sellers with distribution centers in Tennessee
- Expands sales tax to include remotely accessed software
- Adds a presumption of "click-through" nexus for sales and use tax purposes for certain dealers

In this Tax Alert we summarize these Tennessee tax law changes that have various effective dates, as specified below.

### Economic Nexus for Business Tax and Franchise and Excise Tax

Effective for tax years beginning on or after January 1, 2016, the Act broadens the definition of "substantial nexus in this state" for both business tax and franchise and excise tax purposes and implements a "bright-line presence" threshold. Under the Act, a taxpayer has substantial nexus in the state if:

- (1) The taxpayer is organized or commercially domiciled in Tennessee;
- (2) The taxpayer owns or uses its capital in Tennessee;
- (3) The taxpayer has systematic and continuous business activity in Tennessee that has produced gross receipts attributable to Tennessee customers;
- (4) The taxpayer licenses intangible property for use by another party and derives income from that use in Tennessee;<sup>2</sup> or
- (5) The taxpayer has bright-line presence in Tennessee, meaning any of the following apply:
  - a) The taxpayer's total receipts in the state during the tax year exceed the lesser of \$500,000 or 25% of its total receipts everywhere;
  - b) The average value of the taxpayer's real and tangible personal property owned or rented and used in the state during the tax period exceeds the lesser of \$50,000 or 25% of the average value of all the taxpayer's total real and tangible personal property; or
  - c) The total amount paid in the state during the tax period by the taxpayer for compensation exceeds the lesser of \$50,000 or 25% of the total compensation paid by the taxpayer.<sup>3</sup>

Companies treated as foreign corporations for federal tax purposes that have no effectively connected income in the United States shall not be considered to have substantial nexus for Tennessee income and franchise tax purposes. If a company treated as a foreign corporation for federal tax purposes has effectively connected income, then its net earnings and net worth for Tennessee purposes shall be its net earnings and net worth associated with its United States trade or business, in accordance with the Internal Revenue Code. Likewise, its apportionment

<sup>1</sup> H.B. 0644, 2015 Leg., 109th Gen. Assemb., Reg. Sess. (Tenn. May 20, 2015), amending Tenn. Code Ann. Title 67, Chapter 4, Part 20; Title 67, Chapter 4, Part 21; Title 67, Chapter 4, Part 7; and Title 67, Chapter 6.

<sup>2</sup> The intangible property provision only applies to franchise and excise tax nexus, not to business tax nexus.

<sup>3</sup> H.B. 0644, 109th Gen. Assemb., Reg. Sess., Sections 3, 6 (Tenn. 2015).

factors for Tennessee purposes shall be the property, payroll, and receipts effectively connected to its United States trade or business.<sup>4</sup>

### **Triple-weighted Sales Factor Apportionment Formula**

Effective for tax years beginning on or after July 1, 2016, the Act replaces the current double-weighted sales factor formula by implementing a triple-weighted sales factor under the statutory apportionment formula used to calculate the portion of net earnings and net worth apportioned to the state for franchise and excise tax purposes. The Act calls for net earnings and net worth to be apportioned by multiplying the net earnings by a fraction—the numerator of which is the property factor, plus payroll factor, plus three times the receipts factor, and the denominator of which is five.<sup>5</sup>

### **Change to the Excise Tax Deduction for Intangibles Expenses Paid to an Affiliate**

Tennessee law currently provides an excise tax deduction for intangible expenses paid to an affiliate if a taxpayer meets one of three safe harbor exceptions, or if the taxpayer submits an application to take the deduction and the application is approved by the Department of Revenue (“Department”) Commissioner. The Act eliminates the application process and revises the safe harbor provision. Effective for tax years beginning on or after July 1, 2016, intangible expense paid to an affiliate may be deducted if the expense is disclosed, and:

- (1) The affiliate to whom the expense has been paid, accrued, or incurred is registered for and paying the excise tax; or
- (2) The expense was paid, accrued, or incurred to an affiliate in a foreign nation that is a signatory to a comprehensive income tax treaty with the United States or to an affiliate that is otherwise not required to be registered for or to pay the excise tax.<sup>6</sup>

### **Market-based Sourcing for Sales Other than the Sale of Tangible Personal Property**

Effective for tax years beginning on or after July 1, 2016, the Act provides for market-based sourcing for excise and franchise tax apportionment purposes, replacing the current cost-of-performance method for sourcing sales other than the sale of tangible personal property. Under the market-based sourcing approach, receipts from sales, other than from the sale of tangible personal property, are in Tennessee if and to the extent the taxpayer’s market for the sale is in Tennessee. The taxpayer’s market for a sale is in the state:

- (1) In the case of real property, to the extent the property is located in the state;
- (2) In the case of tangible personal property, to the extent the tangible personal property is in the state;
- (3) In the case of a service, to the extent the service is delivered to a location in the state; and
- (4) In the case of intangible property, to the extent the intangible property is used in the state.

If the location of the sale cannot be determined, a reasonable approximation should be used; if the location cannot be reasonably approximated, then the sale should be thrown out of the sales factor. The Act does not further define what constitutes the market, but the Department is expected to promulgate regulations to clarify this issue prior to the effective date.

These sections also provide for an updated total receipts formula for telecommunications services.<sup>7</sup>

### **Elective Apportionment for High-volume Sellers Operating Distribution Centers in Tennessee**

Effective for tax years beginning on or after January 1, 2016, the Act creates an elective apportionment calculation, for franchise and excise tax purposes, for high-volume sellers who choose to use distribution centers located in Tennessee. To qualify, a taxpayer’s sales of tangible personal property in Tennessee must exceed \$1 billion and the taxpayer’s Tennessee receipts factor must exceed 10%. Qualifying taxpayers will be entitled to elect to exclude such sales from their receipts numerator, and instead pay a graduated “gross receipts” tax on those excluded receipts (ranging from 0.125% to 0.5%, depending on the amount of certified distribution sales).<sup>8</sup>

### **Expansion of Sales and Use Tax to Include Remotely Accessed Software**

Effective July 1, 2015, the Act provides that for purposes of the sales and use tax on the use of computer software, such use is defined to include:

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<sup>4</sup> *Id.* at Section 6.

<sup>5</sup> *Id.* at Sections 8, 16.

<sup>6</sup> *Id.* at Section 28.

<sup>7</sup> *Id.* at Sections 9, 17.

<sup>8</sup> *Id.* at Section 14.

access and use of software that remains in the possession of the dealer who provides the software or in the possession of a third party on behalf of such dealer. If the customer accesses the software from a location in this state 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.<sup>9</sup>

This law change exempts any dealer who purchases computer software only for reselling access and use of the software;<sup>10</sup> it also exempts software developed by an affiliate.<sup>11</sup> Also, the new law allows for multiple points of use sourcing based on the percentage of software users located inside and outside of Tennessee.<sup>12</sup>

The Department is expected to promulgate regulations related to the taxation of software as a service; however, the regulations will not be released prior to the effective date of the law. Prior to formal guidance from the Department, taxpayers should examine each sale on a case-by-case basis to determine if the transaction is a taxable sale of software or an exempt service.

### **A Presumption of Click-through Nexus for Sales and Use Tax Purposes**

Effective July 1, 2015, the Act creates a presumption of “click-through” nexus for sales and use tax purposes if: 1) a dealer enters into an agreement with a person located in Tennessee under which such person refers potential customers to the dealer whether by an Internet link, website, or other means; and 2) the dealer’s cumulative gross receipts from retail sales made by the dealer to customers in Tennessee who are referred to the dealer by all such persons who have entered into this type of an agreement with the dealer exceed \$10,000 during the preceding twelve months.<sup>13</sup>

### **ASC 740 Treatment**

The Tennessee Legislative record confirms that the income tax law changes discussed in this Tax Alert were enacted on May 20, 2015. Accordingly, any impact of these law changes should be treated as a second quarter event for financial statement purposes for calendar year taxpayers.

### **Considerations**

Taxpayers with a significant market and sales presence in Tennessee should review the effects the new law will have on their tax reporting and compliance obligations, as well as the potential financial statement impact. Owing to the new nexus provisions, taxpayers with no prior nexus with Tennessee may now have a filing obligation for both income and indirect tax purposes. Additionally, taxpayers with significant sales into the state but minimal property and payroll within the state may see a significant increase in their franchise and excise tax and business tax liabilities. Also, technology companies should examine their revenue streams to determine whether their product offerings would be subject to sales or use tax after the law change.

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If you have questions regarding the Tennessee Revenue Modernization Act or other Tennessee tax matters, please contact any of the following Deloitte Tax professionals.

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<sup>9</sup> *Id.* at Section 22.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at Section 25.

<sup>12</sup> *Id.* at Section 22.

<sup>13</sup> *Id.* at Section 27.

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