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A Washington National Tax Services (WNTS) Publication

April 28, 2012

Tennessee Governor signs amended intangible expense addback legislation

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On April 27, 2012, Tennessee Governor Bill Haslam (R) signed legislation that changes the state's intangible expense deduction provisions by requiring pre-approval from the Department of Revenue (the "Department") to claim the deduction in most cases. [H.B. 2372, enacted 4/27/12]

Background

Under current law, taxpayers that incur intangible expenses as a result of transactions with related parties are required to add back such expenses on their franchise and excise return by way of an addition modification for intangible and interest expenses, but may then claim a corresponding subtraction modification if facts relating to the transaction are properly disclosed on the required form. Related parties receiving such intangible and interest income are eligible to take a subtraction modification for the intangible income if the related payor does not provide the required disclosure. Failure of the payor to disclose such transactions would, if deducted, result in the Commissioner adding back such deductions and imposing a 50 percent negligence penalty.

The Commissioner also has the statutory authority to make multiple discretionary adjustments to related party transactions in order to prevent an evasion of tax, to fairly reflect income, or to disregard transactions or entities that have no business purpose. Over the past three years, the Department has relied heavily on these discretionary powers to disallow deductions for intangible expenses that, while properly disclosed, lacked business purpose or adequate substance. The proposed legislation is intended to mitigate this need for discretionary adjustments by requiring pre-approval.

Pre-approval process

Under H.B. 2372, as enacted, the disclosure provisions are repealed. The legislation requires taxpayers that are paying intangible expenses to affiliated companies to file an application with the Commissioner and receive advanced approval before deducting such expenses. To receive approval, taxpayers must demonstrate that such expense, or portion thereof, does not have as its principal purpose the avoidance of tax.

Approved applications would remain effective so long as the taxpayer provides annual certification that the facts and circumstances surrounding the transaction remain substantially unchanged. The Commissioner is also vested with the authority to require reapplication after five years; however, this authority appears to be discretionary. If the application is denied, and a taxpayer nevertheless deducts the expense, the Commissioner shall assess any applicable tax, interest and penalties resulting from the disallowance of such deduction.

Further, the legislation provides that if the application is submitted to the Commissioner at least sixty days before the due date of the return and the Commissioner has not acted on the application by the due date of the return, no penalty will be assessed on any disallowance of the deduction for intangible expenses and no interest shall accrue until the Commissioner denies the application.

Exceptions to pre-approval

While a pre-filing disclosure/application is required, the legislation provides for exceptions to pre-approval where the intangible expenses were paid to affiliates located in a country that has a comprehensive income tax treaty with the United States, and to affiliates that pay, accrue, or incur such expenses, directly or indirectly, to an unrelated third party.

An exception is also provided where the intangible expenses were paid to affiliates doing business in or deriving income from a state that imposes a tax on or measured by net income and the affiliate is subject to an income tax in that state. For purposes of this provision, "state" means a state of the United States, including the District of Columbia, and any United States possession or territory. However, "state" does not include those states where the taxpayer and affiliate file or are included in a combined return, a consolidated return, or any other return of net income that includes the taxpayer and the affiliate and where such return results in the affiliate's intangible income being offset or matched by the taxpayer's deduction in that state's return. For purposes of this exception, the portion of the intangible expense that will be approved for deduction is that portion that has been allocated or apportioned by the affiliate to that state.

Taxpayers whose circumstances fall into an exception from the pre-approval process for the deduction are entitled to provide notice to the Commissioner at the time of filing their returns, rather than making application sixty days prior to the due date of the return. Further, the Commissioner may, through a conference with the taxpayer, review the facts and circumstances of the proposed intangible expenses deduction, and agree by letter that the taxpayer is relieved of the requirement to file an application.

Other changes

The legislation also modifies the existing subtraction for intangible income such that it would apply to intangible income included in the "affiliate's Tennessee net earnings or net losses" and not deducted by the affiliate because the application for deduction is either not made or not approved.

Among other changes, the legislation also modifies the definition of intangible expenses to explicitly include interest expenses that are "directly or indirectly for, related to, or in connection with the direct or indirect acquisition, maintenance, management, ownership, sale, exchange, or disposition of intangible property."

The legislation is effective upon becoming law and shall apply to all tax years ending on or after July 1, 2012.

PwC Observes

"Taxpayers will be entering a new and unique phase of statutory add back regimes whereby the ability to deduct, subject to certain bright line exceptions, is dependent upon prior approval from the state," notes Kelly Smith, PwC Partner in Atlanta. "It will be interesting to see just how many taxpayers go through the exercise of making these requests, and will be even more interesting to see just how the Department will administer the applications."

"If the lessons learned during the rash of variance adjustments the Department issued over the past few years hold true, the ability of a taxpayer to secure an approval for deduction will likely hinge principally on the degree of economic and legal substance of the related entity receiving the income. As such, taxpayers whose licensing affiliates engage in only limited business activities may see their applications denied, while taxpayers demonstrating a high degree of substance in their licensing affiliate may stand a good chance of receiving approval. I strongly recommend that taxpayers temper what is likely going to be a natural degree of cynicism that all applications will be denied, and that they try to secure the deduction if they believe they have good business purpose for the transaction, even though the so-called "substance" of the related entity may be limited. While the Department disallowed deductions for a great many intangible licensing structures during the previous two years, they also allowed deductions in a great many instances. Accordingly, while I would expect to see a large volume of applications denied, it would not surprise me if a considerable number were likewise approved."

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