Tennessee Enacts the Revenue Modernization Act, Which Adopts New Cloud Computing Use Tax, Overhauls the Franchise and Excise Tax, and Eliminates or Modifies Tennessee Tax Credits

SUMMARY

On May 20, 2015, Tennessee Governor Bill Haslam (R) signed House Bill 644, the Revenue Modernization Act ("RMA"), as well as House Bill 291 ("H.B. 291"), into law. Together, these bills make changes to the Jobs Tax Credit and other credits which may require action by July 1, 2015, and beginning July 1, 2015, the RMA subjects "cloud" software to use tax to the extent used in Tennessee. In addition, the RMA adopts "click-through" nexus for Sales and Use Tax purposes and overhauls Tennessee's Franchise and Excise Tax by adopting economic nexus, a triple-weighted sales factor, and market-based sourcing for sales of other than tangible personal property, and making more changes to Tennessee's affiliated intangible expense add-back statute.

DETAILS

New Use Tax on Cloud Computing

Effective July 1, 2015, the RMA imposes sales and use tax on a Tennessee business or individual accessing software "in the cloud" or software as a service ("SaaS"). Accordingly, a taxable use of computer software in Tennessee will include the right to access and use software that remains on a server hosted in another state by the cloud vendor or third-party host. If the purchaser has users inside and outside Tennessee that have a right to access the software, the sales price or purchase price may be allocated based on the number of Tennessee users to determine use tax.

Modifications to Tax Credits

<u>Franchise and Excise Tax Jobs Tax Credit</u>

H.B. 291 expands the Jobs Tax Credit to apply to "back office operations." However, the bill also eliminates the Jobs Tax Credit for certain projects unless action is taken prior to July 1, 2015. For example, except as to a taxpayer that files a business plan with the Department of Economic and Community Development by July 1, 2015, the bill eliminates a regional headquarters facility as a qualifying business for purposes of the credit. As a result, only if a taxpayer's "sole" international or "sole" national headquarters is located in Tennessee will "headquarters-related functions and services" qualify as headquarters jobs for purposes of the Jobs Tax Credit on or after July 1, 2015. Further, except for business plans filed prior to July 1, 2015, the additional headquarters relocation Jobs Tax Credit will be eliminated. Despite these eliminations that may require time-sensitive action, the bill removes a sunset date problem by removing the requirement that a job position must be filled prior to January 1, 2016, for it to be "qualifying."

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Sales and Use Tax Qualified Headquarters Facility Credit
Similar to the Franchise and Excise Jobs Tax Credit, effective July 1, 2015, H.B. 291 excludes a regional headquarters facility from the application of the credit.

Other Tax Credits
H.B. 291 also repeals a number of lesser known and used Sales and Use and Franchise and Excise tax credits, except for business plans filed with the Department of Economic and Community Development before July, 1 2015. In addition, the legislation requires the Department of Economic and Community Development and the Department of Revenue to review and evaluate the economic impact of Excise, Franchise, and Sales and Use Tax credit programs and draft a report which includes recommendations for modification, discontinuance, or no action.

Overhaul of the Franchise and Excise Tax

Subject to differing effective dates, the RMA makes the following significant changes to Tennessee's Franchise and Excise Tax:

Economic Nexus
Effective for taxable years beginning on or after January 1, 2016, Tennessee will impose Franchise and Excise Tax on a taxpayer that has more than $500,000 in Tennessee sales (regardless of physical presence) or more than $50,000 in Tennessee property or payroll, or whose Tennessee property, payroll, or receipts comprise more than 25% of its total property, payroll, or sales. Tennessee's new "factor presence" economic nexus provisions will apply as well to the Business Tax, Tennessee's state administered local gross receipts tax.

Affiliated Intangible Expense Add-back
Applicable to taxable years beginning on or after July 1, 2016, Tennessee eliminates the application requirement, returns to a disclosure requirement, and relaxes the exceptions to add-back. Tennessee will allow the deduction of an intangible expense paid to an affiliate if the payment is disclosed and the affiliate is registered for or paying the Excise Tax, is not required to be registered for the Excise Tax (i.e., does not have "factor presence"), or is in a foreign nation that is a signatory to a United States income tax treaty. The RMA eliminates the "subject to tax in another state" exception and the "conduit" exception.

Apportionment/Receipts Factor
Applicable to taxable years beginning on or after July 1, 2016, Tennessee triple-weights the receipts factor of the three-factor apportionment formula and adopts a market-based approach to sourcing receipts from sales of other than tangible personal property. See the chart below. Reasonable approximation is allowed where receipts assignment cannot be determined under the primary sourcing rules, but a receipt is required to be excluded from the numerator and denominator of the apportionment factor (i.e., "thrown out") where receipts assignment cannot be reasonably approximated. Under current law, the receipts factor is double-weighted and receipts from sales of other than tangible personal property are sourced to Tennessee using a costs-of-performance approach. As a result, for taxable years beginning on or after July 1, 2016, Tennessee's receipts factor of the apportionment formula will be determined as follows:

Receipts From...	Source to Tennessee If...
… Sales of real property	… Tennessee property
… Sales of tangible personal property	… Destination is Tennessee
… Services	… To the extent the service is delivered to Tennessee
… Rent, lease, or license of non-marketing intangible	… To the extent the intangible property is used in Tennessee
… Rent, lease, or license of marketing intangible	… The underlying good or service is purchased by a consumer in the state
… Sale of intangible property - contract right, government license, or similar intangible that authorizes the holder to conduct a business activity in a specific geographic area	… The geographic area includes all or part of Tennessee
… Sale of intangible property - sales contingent on productivity, use, or disposition of the intangible property	… Treated as a rent, lease, or license of a marketing or non-marketing intangible
… Sale of intangible property - other	… Exclude from numerator and denominator of the receipts factor

Tennessee also adopts: (1) applicable to taxable years beginning on or after July 1, 2016, apportionment changes for securities dealers (net gains from sales of securities will be sourced to Tennessee if the customer is located in Tennessee); (2) applicable to taxable years beginning on or after July 1, 2016, a hybrid market-sourcing costs-of-performance approach to sourcing receipts for taxpayers engaged in the sale of telecommunications service, mobile telecommunications service, Internet access service, video programming service, or direct-to-home satellite television programming service; and (3) applicable to taxable years beginning on or after January 1, 2016, a "Certified Distribution Sales" election that allows a taxpayer to elect to exclude from the numerator of its receipts factor, and instead pay a separate Excise Tax at a dramatically reduced rate on, sales made to a distributor (for ultimate resale outside Tennessee) if the taxpayer has a Tennessee receipts factor that exceeds 10% and sales of tangible personal property to Tennessee distributors that exceed $1 billion. If elected, the separate Excise Tax ranges from 0.5% to 0.125%, depending on the amount of certified distribution sales.

Other Sales and Use Tax Changes

"Click-Through" Nexus

Effective July 1, 2015, the RMA adds a "click-through" nexus provision that imposes a sales tax collection and remittance responsibility on a remote dealer that enters into an agreement with a person located in Tennessee under which the person refers potential customers to the dealer for consideration by a Web site link (or any other means) and, during the preceding 12 months, the dealer's cumulative gross receipts from retail sales to customers in the state under all such agreements exceeds $10,000.

Industrial Machinery Exemption

Also effective July 1, 2015, H.B. 291 expands the sales and use tax exemption for industrial machinery to include machinery and equipment used for the purpose of research and development.

CROSSLIN & ASSOCIATES' INSIGHTS

- Especially for business users of software, cloud computing has become the norm due to its cost savings and efficiencies. The RMA's new use tax on access to SaaS is a departure from Tennessee's administrative position on cloud computing established in a series of letter rulings. Given a July 1, 2015, effective date, Tennessee businesses accessing the cloud for their information technology needs and requirements must quickly determine the impact of Tennessee's new cloud computing use tax.

- Businesses with planned or contemplated headquarters relocations within Tennessee or into Tennessee should take immediate action to prepare and file business plans with the Department of Economic and Community Development prior to July 1, 2015, to be able to secure the full amount of tax credits that will be modified or eliminated after that date.

- Tennessee joins the ranks of many states that have transitioned to market-based sourcing for sales of other than tangible personal property. While this change will most heavily affect service providers, and the change (and a triple-weighted Tennessee sales factor) will not affect Tennessee taxpayers until their taxable years beginning on or after July 1, 2016, Tennessee taxpayers should begin planning for the transition as soon as possible. The Department of Revenue and Tennessee Attorney General are on record stating that regulations will likely be required to implement market sourcing for Tennessee.

- Perhaps as a precursor to an eventual single sales factor apportionment formula, the RMA jumps on yet another trend among states -– the adoption of a more heavily weighted sales factor and the eventual adoption of a single sales factor.

- Tennessee has traditionally been assumed to be a physical presence state for Franchise and Excise Tax purposes, at least for non-financial institutions, based on J.C. Penney National Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 1999). However, for some time, states have been asserting economic presence nexus over taxpayers engaged in financial services or managing and licensing intangible property. A recent trend in the area is the adoption of so-called "factor presence" or "bright-line" nexus statutes by states, and the RMA follows this trend as well. While there will likely be challenges to Tennessee's "factor presence" economic nexus provisions, as there are in other states, the Tennessee Attorney General recently opined that Tennessee's new "factor presence" economic nexus statute "is rooted in a widely-accepted theory of 'economic nexus' that has attained significant currency through court decisions in many states." See Tennessee Attorney General Opinion No. 15-37 (April 22, 2015). Taxpayers should evaluate the impact of, and their transition path to, Tennessee's new economic nexus, apportionment, and tax bases with respect to their Tennessee and multistate operations.

- The RMA continues Tennessee's circuitous experience with affiliated intangible expense disallowance. Beginning in 2004, Tennessee allowed intangible expenses paid to an affiliate to be deducted only if the payor disclosed the payment on its Franchise and Excise Tax return. For taxable years beginning on or after July 1, 2012, Tennessee substantially changed its affiliated intangible expense add-back statute. The 2012 legislation permitted affiliated intangible expense deductions only if (a) the taxpayer filed an application with the Department of Revenue and received "permission" for the deduction, or (b) one of three exceptions was satisfied. For taxable years beginning on and after July 1, 2016, the RMA eliminates the cumbersome affiliated intangible expense add-back exception application process that was enacted in 2012 in favor of a new disclosure requirement. Nonetheless, taxpayers are cautioned that (a) the application process remains in effect for taxable years beginning before July 1, 2016, and (b) the Department of Revenue used the former disclosure procedures to identify taxpayers for audit.