



## Chattanooga Tax Practitioners: The Taxpayer Relief Act of 2012 and Selected TN Tax Update

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# Today's Topics

- American Taxpayer Relief Act
  - Observations and Highlights
- Selected Tennessee Tax Development Update
- Originally planned to include
  - Series LLCs and a segment
  - Tennessee tax incentives

# American Taxpayer Relief Act

# The American Taxpayer Relief Act of 2012



# American Taxpayer Relief Act of 2012

- Fiscal Cliff Legislation – Joint Committee score the cost as \$3.9 Trillion over 10 years (Medicare and Other Health Extenders costs will be estimated by CBO and are not included in above cost)
- Passed by Senate in wee hours of January 1, 2013, passed later the same day by House, signed into law January 2 from Hawaii by the President using an autopen.
  - Legislation in the dark
  - Signed long distance

# The Act was to Address the “Fiscal Cliff”

## ■ What is the “Fiscal Cliff?”

- Tax increases to Clinton era
- Deficit spending
- Debt ceiling
- Entitlements
- Defense spending
- Slow-growth economy
- Insufficient job creation
- National energy policy
- Comprehensive tax reform
- Medicare – physicians and other healthcare spending
- Social Security

### ***All of the Above?***

- What was the January 1, 2013 legislative response?

# American Taxpayer Relief Act of 2012: Primary Provisions

- Extend the “Bush Tax Cuts” for all but individuals over \$400,000/\$450,000 taxable income (indexed)
  - 10% bracket (\$443B)
  - 25%, 28% and 33% brackets (\$320B)
  - Without the Act, the lower brackets would be 15%, 28%, 33%, 35% and the 39.6% bracket would have started at a lower level.
  - Dollar wise about 82% of the Bush Tax Cuts were made permanent. Something the Republican Congress could not do and the Democratic Congress would not do.



# American Taxpayer Relief Act of 2012: Primary Provisions

- 39.6% bracket for those individuals with taxable income in excess of:
  - \$450,000 – married filing jointly or surviving spouse
  - \$425,000 – head of household
  - \$400,000 – single
  - \$225,000 – married filing separately
- Continued equating capital gains and dividend tax rates, although the capital gains rate was increased to 20% for those with income  $\geq$  the above thresholds
  - Note: the 3.8% newly effective tax on investment income remains with lower thresholds and applies to dividends and capital gains.

# American Taxpayer Relief Act of 2012

## Primary Provisions

- Phase out of personal exemptions and phase down of itemized deductions
  - Phase out of personal exemptions at rate of 2% for each \$2,500 (joint return) or portion of income above threshold (\$125,000 above threshold, no personal exemption).
  - Itemized deductions are reduced by 3% of AGI above threshold, but not reduced below 80%.
  - The threshold was reset from what the expiration would have provided. For married filing jointly, the threshold would be about \$267,200 in 2013 under the normal indexing. The Act's threshold is \$300,000 for married filing jointly taxpayers and is adjusted for inflation.

# American Taxpayer Relief Act of 2012

## Primary Provisions

- AMT fix by permanent higher exemptions which are indexed (\$1.8 Trillion)
- No change to the Estate Tax law except increasing the maximum rate to 40%.
- Extenders (including some that are “pork” and others that are “highly focused”)
  - Individual
  - Business
  - Energy

# American Taxpayer Relief Act of 2012

## Primary Provisions

- Unemployment benefits extended 12 months
  - No phase down, full payment until on the street and in the cold.
- Number of Health related provisions, the most notable was one year extension of payments for Medicare patients without 26.5% physician compensation cut.
  - Said to cut approximately \$15B out of hospital payments
- Farm bill extended until September 30, 2013
- Delay sequestration by two months (March 1, 2013)

## Conclusion of Primary Provisions

- America may be out of the individual tax ditch but still on the edge of a real fiscal cliff

# American Taxpayer Relief Act of 2012

## Revenue Figures

- The revenue numbers used in this presentation come for the Senate Finance Committee Preliminary Summary of the H.R. 8, the Act.
  - The JCT numbers may be preliminary
  - Author has not seen the CBO numbers at the time this material was prepared

## Where the Money Is

- The 39.6% tax anticipated to raise \$397B
- Personal exemption phase out \$152B
- Itemized deduction phase down \$152B
- Capital gain increase \$56B
- Estate tax increase of 5% \$19B
- Roth conversions for retirement plans \$12B
- Not scored or discussed is the revenue from starting back up the 2% element of social security tax from 4.2% to 6.2%
- Estimated that 77% of the taxpayers will have higher taxes in 2013 as compared to 2012

# Where the Money Goes

- The cost for the retention of the “Bush tax cuts” rate provisions is a lot of “play money”. Those rates were not going to be raised for the bulk of Americans (as a result of political campaign, those with \$250k were at risk, consistent with campaign strategy, but not the rest).
- Same for itemized deductions and personal exemptions.
  - 10% bracket \$443B
  - 25%, 28% and 33% bracket \$320B
  - Itemized deductions and personal exempt \$10.5B
- AMT was never going to kick in. Even a more staggering amount of “play money”. \$1.8 Trillion



## Where the Money Goes

- Permanent extension of the up to \$1,000 per Child Tax Credit \$354B
- Extension of marriage penalty relief for standard deduction, the 15% bracket and the EITC \$85B
- Permanent exclusion for employer provided education \$11.5B
- Permanent student loan interest AGI deduction \$2,500 per yr with phase out for income between \$55k and \$70k (\$110,000/\$140,000 joint) \$10B

# Where Money Goes

- Permanent extension of increased adoption tax credit and adoption assistance program \$5.6B
- Permanent estate and GST \$5 million (indexed) with top rate at 40%, portability of unused estate tax exemption, permanent reunification of estate and gift tax rate schedule. \$396B
- Five year extension of American Opportunity Tax Credit – up to \$2,500 of tuition and related expenses (100% of first \$2,000 of tuition, 25% of next \$2,000) 40% refundable. Phase out for AGI greater than \$80K (\$160,000 joint) \$67B
- Permanent expansion of dependent care credit \$1.8B
- 2013 mortgage debt relief of up to \$2 million (\$1 million if filing separately) on residence \$1.3B

# Where Money Goes

## ■ Select Business Extensions (2012,2013)

<b>Extender</b>	<b>Amount</b>
▪ R&D Credit	\$14 billion
▪ Work Opportunity Credit (for targeted groups)	\$1.8 billion
▪ §179 Extension	\$2.4 billion
▪ Exception of SubF for Active Financing Income of Foreign Subsidiary	\$11.2 billion
▪ Qualified Small Business Stock 0% Capital Gain Tax	\$1 billion
▪ Bonus Depreciation	\$5 billion
▪ 15-year straight line depreciation for qualified leasehold improvements, restaurant buildings and qualified retail improvements	\$3.7 billion

# Where Money Goes

## ■ Select Energy Tax Extensions (2012,2013)

<b>Extender</b>	<b>Amount</b>
■ Credit for certain nonbusiness energy property (§25C) energy improvements to existing homes	\$2.4 billion
■ Credit for biodiesel and renewable diesel – \$1 per gallon of biodiesel or diesel created from biomass (algae added to mix)	\$2.2 billion
■ Extension of 2.2 cents per KW hour tax credit for wind electricity produced for 10-year period for facilities that begin construction (not placed in service) by end of 2013	\$12 billion

# Where the Money Goes

- Unemployment benefit extension \$30B
- No revenue scores yet seen for Healthcare provisions (provided by CBO vs JCT)
- No revenue scores yet seen for extension of farm bill

## Pork and Political Spoils?

- Per WSJ estimates, \$40B in “tax payoffs to every crony capitalist and special pleader with a lobbyist worth his million-dollar salary”.
- Inclined to believe the WSJ number is a bit high and many of the extenders are valid policy. However,
  - Michigan International Speedway Nascar – 7 year recovery period \$78 million
  - Companies operating in American Samoa, including StarKist \$62 million (Jeff Bingaman D-NM)
  - Puerto Rico and US Virgin Island distillers get an excise tax rebate on rum \$222 million (\$13.25 per gallon)

# Pork and Political Spoils?

- Film and TV production expensing of first \$15 million (\$20 if substantial costs incurred in economically depressed areas). \$248 million
- **Focused benefits** (*personal observation /speculation*)
  - Are some specific developer(s) of low income housing running behind and unable to place in service in time? \$8 million
  - Indian employment tax credit (up to \$20,000 per employee \$119 million [Having been on a reservation and met Indian leaders trying to make a difference. Bureau of Indian Affairs mismanagement over the decades have harmed a decent people. I have sympathy for this, but not sure it is good tax policy.]

# Pork and Spoils?

- Accelerated depreciation for business property used on an Indian reservation \$222 million
- Indian country coal production credit \$1 million – Facilities must have been placed in service before 2009
- Credit for Class II and Class III railroads for maintaining tracks \$331 million
- Extension of biodiesel and renewable diesel used as fuel exemption from excise tax until December 31, 2013 (benefit for 2012 and 2013)
- Mine rescue team training (expense of up to \$10,000 per employee) \$5 million
- Several energy extenders involve areas of GE heavy involvement – for example, wind with \$12B cost



# The Third Sequel

- The next sequel of peril will be in the political theater before March 1.
- The key terms:
  - Additional investments (i.e., additional government spending)
  - Balanced approach – additional taxes on the wealthy and perhaps business community
    - Up to now, no discussion of the additional taxes (and other costs associated with Healthcare that will kick in 2014)
    - Will be harder (more expensive) to hire “full time” – 32 hours a week – employees.
  - Tax reform (probably a code for more taxes as opposed to a more competitive system)

# The Third Sequel

## ■ Elements

- Debt Ceiling
- Medicare and Social Security
  - The various credits for low income of the Act and the extension of unemployment probably took one segment of entitlements largely off the table.
- Defense spending
- Taxes
- Will a national energy policy be in the mix?

## Next Sequel Before 3/1/2013 Audience Participation Required

- President Obama's words, December 31, 2012
  - But keep in mind, we're going to still have more work to do. We still have deficits that have to be dealt with. We're still going to have to think about how we put our economy on a long-term trajectory of growth, how we **continue to make investments** in things like education, things like infrastructure that help our economy grow.

## Next Sequel Before 3/1/2013

# Audience Participation Required

- And I want to make clear that any agreement we have to deal with these **automatic spending cuts** that are being threatened for next month, those also **have to be balanced** -- because remember, my principle has always been let's do things in a balanced, responsible way. And that means that revenues have to be part of the equation in turning off the sequester, in eliminating these automatic spending cuts, as well as spending cuts.
- Now, the same is true for any future deficit agreement. Obviously, we're going to have to do more to reduce our debt and our deficit. I'm willing to do more, **but it's going to have to be balanced**. We're going to have to do it in a balanced, responsible way.

## President's Remarks Seems to Be Focused on Efforts such as Those of Senators Alexander and Corker

- The “Corker-Alexander Dollar-for-Dollar Plan” would reduce the growth of entitlement spending (Medicare, Medicaid and Social Security) by nearly \$1 trillion in order to improve the programs’ solvency. In exchange, Congress would approve the president’s expected request for a \$1 trillion increase in the debt ceiling.
  - Latest Medicare Trustees report, which says that in 2024 (11 years), Medicare won’t be able to pay all its benefits. When the Hospital Insurance Trust Fund is exhausted, the Trustees estimate that revenues into the program will only be sufficient to cover 87 percent of costs.
- Summary and text of legislative language can be found on web site of Senators Alexander and Corker.

# What are the Political Battles?

- Comprehensive tax reform.
  - How to make corporate American (what about pass-through America which is over 50% of business revenue) more competitive and yet raises taxes?
    - Rhetoric may be reform. Action may be distribution money.
  - What additional individual income tax changes loom for shared sacrifice?
    - Republicans say revenue side now fixed.
    - President calls for more “shared sacrifice” and “balance”.

## What Changes to Entitlements to Keep them Solvent and Future Functioning?

- President seems to recognize that Medicare will require some changes - December 31, 2012 statement:

"I'm willing to reduce our government's Medicare bills by finding new ways to reduce the cost of health care in this country. That's something that we all should agree on. We want to make sure that Medicare is there for future generations. But the current trajectory of health care costs is going up so high we've got to find ways to make sure that it's sustainable."

- Looks more like he is thinking of cutting payments than structural change.

## What Changes to Entitlements to Keep them Solvent and Future Functioning?

- December 31, 2012 Statement of President:

“But that kind of reform has to go hand-in-hand with doing some **more work to reform our tax code so that wealthy individuals, the biggest corporations can't take advantage of loopholes and deductions that aren't available to most of the folks standing up here -- aren't available to most Americans.** So there's still more work to be done in the tax code to make it fairer, even as we're also looking at how we can strengthen something like Medicare.”



## Specific Provisions

- I have made a taped presentation on The Taxpayer Relief Act of 2012 for the TSCPA and it is available (or will be soon) on the web.
- In addition to the above, points, I cover selected extenders in the Act as well as Estate Planning after the Act. There is one specific extender I wish to point out today as it requires action by January 31.

## IRA Provision Requiring Immediate Action

- Tax free distributions to charity from IRA held by someone age 70 ½ or older of up to \$100,000 per year.
- Act extends this provision for 2012 and 2013.
  - Recognizing that this is now 2013, the Act provides that an individual can have an IRA distribution made in January 2013 deemed made on December 31, 2012.
  - Individuals who took a distribution in December 2012 able to contribute the amount to a charity in cash before February 1 and count as eligible charitable rollover to extent otherwise meets requirement for eligible charitable rollover.
    - If took distribution earlier in the year and would like to have it treated as an eligible charitable rollover – too bad.

## IRA Provision Requiring Immediate Action

- Remember the phase out of itemized deductions for 2013. May have clients that need to take advantage of 2012.
- Avoid the 50% AGI limit on charitable deductions. A qualified IRA to public charity contribution is not reported as income to individual.
- Community foundations are public charities, but the IRA direct contribution cannot be made to a donor advised fund. It can be made to a fund that the community foundation has that is not donor advised.

# Perils of Pauline



## Perils of Pauline and the Fiscal Cliff

- The ongoing political/fiscal events of creating one fiscal/tax crisis after another reminds me of the 1914 American film serial “The Perils of Pauline.”
- The lovely lady on slide 5 is Pauline.
- Pauline, the resourceful heroine, ends each episode with an unresolved deadly danger that must be resolved in the next installment.
- One can go back earlier, but a potential first installment of the Pauline series playing today is the 2011 sequestering legislation and raising of the debt ceiling.

- The fiscal tax ditch relief of the Act is the second resolution of this series and began with Pauline's picture.
- Pauline now remains in peril, hanging over the fiscal cliff on a small branch as the country lurches toward the next series of debt ceilings, spending cuts, and more taxes.
- The Perils of Pauline had 30 episodes. Let's hope America finds its own happy ending in fewer installments.

# Selected Tennessee Tax Developments Update

## Required Electronic Filings

- In 2012 legislation the Commissioner was given authority to require electronic filing of any return, report, claim, statement, application or other document, and any payment or remittance accompanying the document, that is filed with the TDOR.
  - Effective no sooner than 90 days after Comm certified by notice on TDOR web site that system is in place for electronic submission of such documents and payments.
  - Comm will permit paper filing if hardship on taxpayer.
  - Comm may require any paper filing be accompanied by manual filing fee not to exceed \$25 with cumulative total for any one taxpayer in a 12 month period of \$50.



# Required Electronic Filings

- Initial web notice is up.
- In addition to returns previously required to be filed electronically, starting for returns filed on or after January 1, 2013 the following are required to be filed electronically:
  - All franchise and excise tax returns prepared using software certified by the TDOR (list is linked on TDOR site)
    - Will need to set up EFT account or use credit card for payment
  - Sales and use tax returns for taxpayers with an average tax liability of \$500 or more
  - Professional privilege tax.
    - Either by individuals or
    - Companies that file and pay for multiple individuals

# Electronic Filings

- The Commissioner is seeking to make the TDOR more efficient by moving toward electronic filing, information gathering and payments.

# Electronic Efficiency For Determination of Income

- Tennessee “minute markets” have been an ongoing compliance issue for the TDOR. (Informal observation of announced indictments seem to be disproportionately weighted to these establishments.)
- 2012 legislation permits the Commissioner to require beer and tobacco wholesalers to report to the TDOR the sales by location to their customers.
  - Goal is to match the activity on these items with the reported sales of convenience and other retailers.
- The first report for January through November 2012 was due December 30, 2012.
  - Thereafter, monthly 20 days in arrears
  - Failure to file is a penalty of \$1,000 per month up to a maximum of \$10,000

# Acceptability of Out-of-State Exemption and Resale Certificates

- Tenn Ltr Ruling 11-61
- TDOR will accept
  - Electronic versions of Streamlined Sales Tax Certificate of Exemption
  - Scanned copies of both Tennessee and Streamlined Exemption Certificates
  - Accepts out of state resale certificates
  - Not accept out of state exemption certificates
  - Will accept out of state purchaser's 501(c)(3) exemption letter

# Repeal of Tennessee Gift Tax

- This was a stealth repeal. We understood it was happening, but all the publicity and talk was on the phase out of the TN inheritance tax.
- TN was only one of two states left with a gift tax (Conn is the other). The Class A and Class B dichotomy and the lack of coordination with the federal annual exclusion was an expensive surprise for many.
  - Federal annual exclusion for 2012 is \$13,000 and for 2013 is announced to be \$14,000. This is per donor, per donee.
- Tax was repealed for gifts made on or after January 1, 2012!
- Facilitate the major gifts that are being made in light of the scheduled reduction of the federal unified credit

## Phase out of TN Inheritance Tax

- Inheritance tax rate starts at 5.5% and rises to 9.5% on the taxable estate above \$440,000.
- The exemption is increased each year with a repeal of the inheritance tax in 2016.
- The exemption amounts are:
  - Decedents passing in 2012: \$1 million
  - Decedents passing in 2013: \$1.25 million
  - Decedents passing in 2014: \$2 million
  - Decedents passing in 2015: \$5 million
  - Repealed for 2016 and subsequent years

## Potential Surprise With Respect to Gifts Made and Inheritance Tax

- Although the gift tax was repealed, the inheritance tax law (TCA 67-8-304(3)) pulls gifts made within 3 years of death back into the estate upon which the inheritance tax is computed.
- Gifts made in 2012 and subsequent years are subject to being taxed by the Tennessee inheritance tax if the donor passes within 3 years unless the death of the donor is January 1, 2016 or later.

# Process for Estate Tax Repeal

- The economist, Art Laffer, prepared a study showing the adverse economic and job impact the inheritance tax has had on Tennessee
- This study also statistically supported the antidotal reports of significant movement of wealthy older Tennesseans to other states to avoid the Tennessee death tax
- This study also projected an increase in the number of people retiring to Tennessee from other states.



## Anticipated Effort to Repeal or Modify the Hall Income Tax in 2013

- Former Governor Phil Bredeson wanted to repeal the Hall Tax in his second term as Governor.
- In addition to the tax cost to the State of Tennessee, certain local governments with significant Hall Tax revenue were violently opposed to such action.
- Although receipts vary greatly from year to year, in FY 2008 (year 2007) \$213 million from 192,000 households.
  - In FY 2010 the Hall receipts were \$170 million
    - \$106 million for State
    - \$ 64 million for County and Municipal governments

# Anticipated Effort to Repeal or Modify the Hall Income Tax in 2013

- 3/8 of the Hall Tax goes to County and Municipal Governments
- FY 2010 (the following counties including municipalities received):
  - Knox Co.           \$12.5 million
  - Shelby Co.       \$11.4 million
  - Davidson Co.     \$10.4 million
  - Hamilton Co.     \$ 5.0 million
  - Williamson Co.   \$ 4.5 million
  - Sullivan Co.      \$ 1.4 million
  - Sumner Co.       \$ 1.3 million
  - Hancock Co.      \$ 2,775

## Anticipated Effort to Repeal or Modify the Hall Income Tax in 2013

- Senators Sargent and McNally have said they would sponsor a bill in 2013 to repeal the Hall Tax
  - Speculation is a phase out similar to that of the inheritance tax to ease into the revenue loss.
  - Expect opposition of municipalities and county governments with significant revenue – resistance of counties without significant revenue for “hold harmless”.
  - Significant revenue loss to state as well.

## Potential Legislation to Move Appeals to an ALJ Function in the Secretary of State Office

- It is anticipated that legislation may be introduced to move the informal appeals conferences to a more formal administrative law judge hearing under the auspices of the Secretary of State Office.
- Some have a feeling that TDOR operation of Appeals is not impartial.
- A more formal process is likely to increase the cost of such appeals and may well require such matters to be handled by attorneys only.
- It should be noted that in Tennessee, the informal conference is exactly that. It does not create a record for judicial review or preclude the taxpayer from going to court de novo.

## Potential Legislation to Move Appeals to an ALJ Function in the Secretary of State Office

- Factoids that the Commissioner presented at the State Tax Liaison Meeting in December using fiscal year ended 2012, included:
  - 11,537 desk or field audit adjustments
  - 375 conference requests
  - 101 resolutions before conference
  - 239 conferences held
  - 121 had some adjustment in favor of Taxpayer/133 no change (minor or major change in favor of taxpayer)
  - 14 of matters heard by conference went to court

# Potential Legislation to Move Appeals to an ALJ Function in the Secretary of State Office

- Demand by some for hearing results for guidance
  - Negotiation resolutions with auditor and supervisors are not published
  - Quasi-precedent setting likely to lead to more procedural and formal matters and more formal results
  - Greater cost but likely a larger role for attorneys
- Unclear that it would benefit taxpayers.
  - Taxpayers are not required to go to informal conference;
  - Taxpayer can withdraw from informal conference at any time and go to court or can go to court after conference.
  - Trial court is de novo and the informal conference is not

# Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- For tax years ending on or after July 1, 2012
- TP must file with TDOR in advance of filing the Excise Tax Return form "IE-A" – "Intangible Expense-Application for Approval to Deduct"
  - If TP takes a deduction without advance approval that is later disallowed, then subject to penalties and interest.
    - Potential penalty is 50% negligence penalty. Statute says "shall"
  - If file before 60 days prior to due date of Excise Tax Return, if not hear from TDOR, will not be subject to penalty if deduction is disallowed.
    - If timely submit and not hear, no interest for 30 days following denial

## Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- This is not a simple form and for many will require significant effort to assemble the information.
- The questions on the form attempt to determine with respect to the affiliate:
  - Type of intangible and asset value
  - Use of funds
  - Whether it uses own employees, contractors, employees of affiliates, etc.
  - Required affiliate's pro forma federal tax return for prior or current tax year



# Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- Listing of other affiliates subject to Tax in TN that are also incurring intangible expenses to affiliate
- Description of business activity of affiliate, locations, number of full time employees per location
- If less than 10 employees the names, titles, work address, job descriptions and day to day activities and if they work for others
- Means by which intangibles transferred to affiliate and copy of transfer documents, if available
- Detailed description of determination of expense amount and independent studies or analysis
- Documents showing actual payments and if loaned back details regarding the loan

# Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- Mandatory (per statute) approval of portion that is:
  - To affiliate in foreign nation that is signatory to comprehensive income tax treaty with U.S.
  - To affiliate who during same tax year directly incurred such portion to a non-affiliate.
  - To affiliate in state that imposes a net income tax and under that state's law affiliate is subject to tax.
    - Apply that state's allocation or apportionment rules to determine amount approved (form does not seem to ask this question).
    - Does not include states where TP and affiliate are included in a combined or consolidated tax return where such return or report results in affiliate's intangible income being offset or matched by TP deduction.

## Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- Per statute, any TP whose deduction is based on the automatic approval criteria shall be entitled to provide notice to Comm at time of filing of return rather than by application 60 days prior to due date of return.
- Through conference with TP, Comm may review facts and circumstances and by letter agree TP may be relieved of requirement to file an application.

## Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- If Comm denies deduction and TP nevertheless claims the deduction, Comm shall assess TP for tax, interest and penalty.
  - Statute states – “shall”
- TP is entitled to standard remedies to contest the assessment.

## Pre-Approval for Excise Tax Deduction for Intangible Expenses to Affiliates

- Approval of intangible expense deduction or portion remains in effect as long as TP submits annually to Comm a certification that facts and circumstances remain substantially unchanged.
  - Comm is authorized to require resubmission for deduction no sooner than five years following the most recent application.

# MISCELLANEOUS TN TAX DEVELOPMENTS

## Hall Tax Applies to Deemed Distribution

- C corporation elects S status
- C corporation has passive investment income and prior "C" corporation E&P
- S corporation can make deemed distribution of prior E&P to maintain federal S status
- Tennessee will impose Hall tax on the deemed distribution.
- Tenn. Ltr. Rul. 12-04 (May 18, 2012)

## Taxation of a LP Composed of two SMLLCs Owned by a Corporation is Taxable

- Tenn. Ltr. Rul. 11-46
- Limited partnership with two LLCs as partners
- Both LLCs are SMLLCs in turn owned by another SMLLC (SMLLC P)
- SMLLCs P owned by a corporation parent
- For federal tax purposes, all income, gain and loss found in corporate parent's return. Rest are disregarded.



# Taxation of a LP Composed of two SMLLCs Owned by a Corporation

- TDOR in Ltr. Rul. 2011-says LP is subject to F&E Tax as a corporation despite being disregarded for federal income tax.
- Analysis of Ltr. Rul.:
  - TCA § 67-4-2007(d) and 67-4-2106(c) provide entities disregarded for FIT, except SMLLC whose sole member is a corporation, are not disregarded.
  - The limited partnership is not a SMLLC
  - Income computed as a corporation because the LP's income, gain and loss are reported on a corporate return. See TCA §67-4-2006(a)(1)
- If start with the LLCs, each are disregarded and there is no partnership. This may be worth fussing over.

## Tennessee Sales and Use Tax and Aircraft

- Companies and individuals purchasing or bringing airplanes for use in Tennessee. There is not much of an audit lottery. The TDOR subscribes to FAA reports and is very very active in the area.
- I have had clients criminally investigated because they had an aircraft they purchased out of state, hangered in Virginia, and then brought to Tennessee for repair and storage.

# Tennessee Sales and Use Tax and Aircraft

- There is a tax efficient way and a tax costly way to bring an aircraft into Tennessee.
- Must do correctly from first step or be subject to the sales tax on the full cost of the aircraft.
- Wrong way – *McIntyre v. Farr (Chancery Court)*
  - Taxpayer was navy captain
  - Purchased aircraft in 2007 for \$156,000 while stationed in Texas (Texas no impose sales tax)
  - Captain was transferred to Millington for a short period
  - Rented a hanger
  - TDOR assessed use tax of \$8,393 against him

# Tennessee Sales and Use Tax and Aircraft

## ■ Right Way

- Purchase by one entity to lease to related entity(s)
  - Generally because of FAA Rules this will be dry lease
  - Also want to stay under FAA Part 91 vs Part 135
- For liability reasons, want to separate ownership from actual operation.
  - We do a fair number of these, including for out of state owners. This structure has real business/liability substance.
  - In Tennessee, is also tax efficient.
  - Aircraft have a tendency to be sold or traded with a degree of regularity
- Important that FAA flight logs and records accurately reflect who flying for and that proper billing and records are maintained.
  - Tax purposes
  - Liability purposes

# Tennessee Sales and Use and Aircraft

- CAO Holdings (went to TN Supreme Court twice)
  - Corp owned by a single individual purchases aircraft (big expensive jet) under a certificate of resale
  - Corp leases to affiliated corporation (same owner) for use – collects sales tax on lease payments
- TDOR Arguments
  - Violated exclusively used for leasing
  - Lease by taxpayer to lessee was illusory
  - Resale transactions between TP and lessee should be disregarded as a sham

# Tennessee Sales and Use and Aircraft

- The ultimate owner (individual taxpayer) was often listed as co-pilot (apparently irritated the TDOR)
  - After a few tens of thousands of dollars of sales tax the owner determined the plane was too expensive and not going to be successfully leased for a profit and sold it.
- Sale for resale
  - Purchase made for purpose of resale
  - Sale in strict compliance with rules and regulations promulgated by TP
- Court ultimately found that the brother – sister corporations were “separate business entities with separate business purposes and independent values.” Rejected sham.
  - Important case for general Tennessee tax planning as well as aircraft in sales and use tax area
- Moral – set up the acquisition or bringing into Tennessee correctly with business purpose and do the proper documentation. File the sales/ use tax returns on the leases timely.

# TN Excise Tax and 754 Elections

- It has been common strategy to sell the interest of an LLC and the buyer to receive the benefit of a step up by virtue of §754 election.
  - Sale of interest by individual, no Tennessee tax, generally capital gain for federal (exception is “hot assets” inside LLC)

# TN Excise Tax and 754 Elections

- Tenn. Rev. Rul. 2011-45 expresses the TDOR's view that no step up on basis for TN franchise and excise tax.
- But see: J. Leigh Griffith, *Disregarding 754 Elections? A Harbinger of Things to Come*, Tenn. CPA Journal, Jan.-Feb. 2012, at 21 for an analysis of a contrary view.