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Chattanooga Tax Practitioners

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Topics

- Tennessee's Revenue Modernization Act as put forth by the TDOR and Governor
- Series LLCs: What are They and Why
- Practice Points
 - Who can sign a Partnership Tax Return
 - Dual Status Partners (W-2 partners)
 - Tennessee - soon to be onslaught of rejected TCA 67-4-2006(b)(1)(N) affiliated intangible expense deductions

Tennessee's Revenue Modernization Act of 2015

HB 644 and SB 603
Pending Litigation

Overview

- Revise (or attempt to revise) nexus standards to a form of “economic nexus” for Tennessee taxes:
 - Business Tax (state portion only);
 - Sales and Use Tax; and
 - Franchise and Excise Tax.
- New standard and burden of proof on affiliated intangible transactions.
- Sales tax on remotely accessed software and remotely accessed video games.
- No Fiscal Note shown on General Assembly website.

“Bright-Line Presence Test”

- Physical presence is not required.
- Deemed to have sufficient presence in Tennessee when during a tax period a taxpayer has:
 - Total Tennessee receipts greater than \$500,000 or 25% of total receipts everywhere;
 - Average value of TPP owned or rented in Tennessee exceeds the lesser of \$50,000 or 25% of average value of TPP everywhere; OR
 - Compensation paid in Tennessee exceeds \$50,000 or 25% of total compensation.

Click Through Nexus for Sales and Use Tax Purposes

- Presumption of nexus for dealer who enters into an agreement with one or more Tennessee persons where, for consideration, such persons refer potential customers to the dealer and the dealer's gross sales from such referrals exceed \$10,000 in the preceding 12 months.
 - Wording is broader than simply internet.
 - Wording is rolling 12 months, not fiscal year.
 - Presumption overcome if shown by CLEAR AND CONVINCING EVIDENCE that no contracted party conducted ANY activities in Tennessee that substantially contributed to seller's ability to establish and maintain market in State for past 12 months. (Proposed effective July 1, 2015.)

Imposition of F&E Tax If License Intangibles for Use in TN

- Following a national trend, Tennessee will impose nexus for F&E Taxes on Taxpayers licensing intangibles for use in Tennessee.
 - Amends TCA 67-4-2004 for substantial nexus to be generated if the TP licenses intangible property for use by another party in this state.
 - This does not appear to have the “bright-line presence test” threshold.

Business Tax

- Would apply to parties:
 - Selling services delivered to Tennessee location;
 - Leasing TPP located in Tennessee;
 - Certain natural gas marketers; or
 - Selling TPP shipped into Tennessee.
 - Note: because of lack of physical location, outlet or other place of business in municipality, local portion does not apply, only state portion.
 - For out-of-state service businesses, this will be interesting
 - must deliver service to out-of-state location as opposed to current rule that excludes services substantially performed in another state.

Sales and Use Tax

- Currently, charges are exempt for software accessed via internet but not acquired when servers are out of Tennessee.
- Act would impose tax starting July 1, 2015:
 - Video game digital products provided remotely;
 - Online computer software access provided pursuant to application service provider (ASP) or software as a service (SAAS)
 - If users in and out of Tennessee, may allocate base on percentage of in-state and out of state users
 - Payment processing services, internet services and online data storage not taxed
 - Interestingly Alabama has 2015 legislation pending for similar imposition of sales tax for online computer software access.

Franchise and Excise Tax

- New nexus for services.
- New optional apportionment (actually a gross receipts test on sales to huge distributors located in TN in lieu of excise tax attributable to such sales – also impacts F&E apportionment).
- Affiliated intangibles licensing and service fee requirements made more stringent.

Services and Sale of Intangibles

- Remember nexus is deemed to occur if receipts exceed \$500,000 or 25% of total receipts everywhere.
- Cost of performance for sourcing receipts from services will be eliminated.
- Market-based-approach sources sales based on deemed delivery location or use location of the intangible or service.
 - Law, consulting, accounting, other firm located out of state (across state line) providing services to Tennessee business???

Deductibility of Intangible Expenses Paid to Affiliate

- Modify TCA Sec. 65-4-2006(b)(2)(N) with respect to advance approval of affiliated intangible expenses to require:
 - Transaction giving rise to expense would be required to have a substantial business purpose (currently only requires that tax avoidance not be the principal purpose); and
 - To overturn Commissioner's determination, taxpayer must show Commissioner incorrect by clear and convincing evidence.
 - *As will be noted in the practice tips portion, a large number of rejections are in the process of taking place. This legislation will assure on a prospective basis the Commissioner will almost always win.*

Companion Legislation

- Although not part of the Revenue Modernization Act, a companion bill with the same sponsors HB 213 and SB 324 would triple weight sales in the three-factor formula.
 - For Tennessee manufacturers involved in multi-state business the bill will generally reduce excise tax.
 - For out of state manufacturers with sales in Tennessee, will generally increase tax.
 - Per General Assembly Web site, No Fiscal Note yet.

Super-Big TN Sales to Distributors – Optional Tax In Lieu of Excise Tax

- Taxpayers with sales of TPP in excess of \$1B in Tennessee to distributors for resale outside Tennessee and such sales are certified.
- Taxpayer's Tennessee receipts factor greater than 10% before election.
- Taxpayer elects, exclude from apportionment of net earnings and net worth the certified distribution sales ("CDS").
- In lieu of regular excise tax a sliding gross receipts tax going from .5% of CDS to .125% of CDS gross receipts in excess of \$4B.

Conclusion

- To make this work, TDOR will need to have much better multi-state audit coverage. Midsize and smaller out-of-state businesses are unlikely to voluntarily comply.
- If other states adopt, businesses will have many more tax returns, record keeping and compliance costs and perhaps higher aggregate taxes.
- Will such a burden on interstate commerce be found to be constitutional?

For More on the Modernization Revenue Act - See

- www.capitol.tn.gov/legislation/
- J. Leigh Griffith, *Tennessee's Pending 'Revenue Modernization Act'*, *TSCPA Journal*, pg. 14-15, Vol. 60, No. 2, March/April 2015.

Series LLCs

Series LLCs

- What are Series LLCs?
- Why?

What are Series LLCs?

- Single LLC with cells or protected series (“PS”) that are part of the LLC.
 - Each PS may:
 - Hold assets;
 - Incur liabilities;
 - Separate management;
 - Separate liabilities from other Series and the SLLC itself;
 - Have different members associated with it.
 - Each PS is protected from the liabilities of the Series LLC or from those of other PS.
 - Each PS is a separate federal income tax reporting
 - See Proposed Treas. Reg. REG-119921-09 which would make several inserts into Treas. Reg. 301.7701-1.

What are Series LLCs? *(Continued)*

- Single state law legal entity.
- Each PS however enjoys “internal liability shields” protecting it from liabilities and obligations of the Series LLC itself and the other PS.
 - Tennessee - TCA Sec. 48-249-309
- Each PS is a separate federal and for most states, separate income tax reporting unit.
 - Tennessee – Letter Ruling 11-42 (Sept. 2011)
 - For 50 state tax analysis see Bruce P. Ely, J. Leigh Griffith, James E. Long, Jr., SERIES LLCs Survey of States’ Response to the Proposed Federal Tax Rules, Business Entities (September/October 2013). Pages 20-27
- Each PS can have its own line of business or investment, its own associated members and its own form of governance (member, director, manager).

What are Series LLCs? *(Continued)*

- Current time there are 12 states, the District of Columbia and Puerto Rico that have passed Series LLC legislation (Alabama's was effective January 1, 2015).
 - Includes Tennessee, Alabama and Delaware.
- National Conference of Commissioners on Uniform State Laws:
 - A few years ago decided not to do Uniform Act.
 - Reconsidered and are now working on Act.
 - Next drafting session is in Chicago this weekend.

New But Not New

- Perhaps a unique concept for widely used business entities, but the cell or series concept has long existed in trust law. See Uniform Statutory Trust Act.
 - Very common in the insurance industry and more recently in the mutual fund industry.

Why?

- They exist in Tennessee and Alabama and you may be dealing with one or your clients may wish to utilize one.
- Very useful in regulated industries as the qualification of the Series LLC will generally qualify each of the PS.
 - Foreclosure Fortress for banks;
 - Permits one time regulatory red tape to form entity and from that point PS can be formed to foreclose on sensitive assets.
- Are being widely used for single state multi-property real estate holdings with each property in a separate PS.

Why? *(Continued)*

- Because single legal entity for state law purposes, sales or rentals between PS should not be subject to sales and use tax (presently no different than divisions of a corporation).
- Also means cannot purchase on resale certificate if transaction is to be between PS (Important for equipment leasing including aircraft!).

Why? *(Continued)*

- Just as with LLCs, creative uses will emerge.
- Example: use to bring different closely held businesses together in a single entity without tax costs (making each PS a disregarded entity or partnership with the existing owners) and retaining existing economics while “rolling up” or “packaging” for a sale.
 - Provides a single entity for a purchaser to purchase but until purchase, separate economics and internal liability shields if in a state that recognizes the internal shields.

Why? *(Continued)*

- Advise clients that they will generally be better served from a liability standpoint if engaged in multi-state business to use a number of LLCs vs. a Series LLC until the states in which the client is involved all have Series LLC statutes.
- If a client will only have one entity (some clients are like that) for various real property investments or other operations, a Series LLC with PSs at least give the client an argument if a liability arises.

Why? *(Continued)*

- Requires accurate books and records properly associating assets and liabilities to each PC in order for the internal liability shields to hold.
- Must understand Series LLCs to be able to audit or prepare financial statements.

Uncertainties

- Will internal shields hold in other states, particularly those that do not have Series LLC legislation?
 - External liability shields should be the same as a regular LLC
- Can a PS bankrupt?

Additional Resources

- J. Leigh Griffith and James E. Long, *Series LLCs – December 2013 Update on Recent State Legislative and Taxation Developments*, 55 Tax Management Memorandum 83 (3/24/2014).

Practice Points

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Practice Tips Partnership Tax Return Execution

- Who can sign a partnership tax return?
 - Code and Regulations – Code Sec. 6063 (any one of the partners); Treas. Reg. Sec. 1.6063-1(a) (any one of the partners).
 - Instructions to 1065 (general partner or member manager).
 - Chief Counsel Advice 2014-25011 (general partner or member manager).
 - IRS may challenge whether the correct person signed the tax return. Primary motivation to void tax elections. Aware of cases involving 754 elections.

Partnership Tax Return Execution *(Continued)*

- If a grantor trust is a partner or member, the trustee must execute for the Trust. Not the grantor.
- If a single member LLC is a partner, the single member must sign for the LLC and not individually (an example where disregarded does not mean what it says).
- Many LLCs have managers who are not members (may have interest through another LLC or Partnership). Even though sign all other contracts, that manager cannot validly sign tax return.

Partnership Tax Return Execution *(Continued)*

- For additional resources, see:
 - Shelton I. Banoff and Allan G. Donn, *Who Can Sign a Partnership's or LLC's Tax Returns? Simple Questions; Complex Answers*, J TAX'N (2010)
 - J. Leigh Griffith, *Any Partner, Member or Manager May Sign a Partnership Return. Right?* Taxes Magazine, April 2015.

Practice Tips Dual Status Partner

- Under current law (See Rev. Rul. 69-184 and GCM 34273), it is the IRS position that a partner cannot be an employee in a partnership in which he or she is a partner.
 - Following Riether, DC-NM, 919 FSupp2d 1140 (2013), the IRS National Office is focused on this issue.
 - Danger for profits interest partner, outside the safe harbor of Rev. Proc. 93-27 as clarified by 2001-43.

Dual Status Partner *(Continued)*

- Dangers for partner includes potential overpayment of employment taxes as W-2 amount is not reduced for other losses employee may have.
- A partner's participation in the employee cafeteria plan can disqualify the plan.
- Unclear that the tax return preparer can meet the substantial authority test for signing the tax return. Code Sec. 6694

Dual Status Partner *(Continued)*

- For additional materials, see:
 - Noel P. Brock, *Treating Partners as Employees: Risks to Consider*, J. Accountancy, Vol. 201 (2014).
 - Noel P. Brock, *Partners as Employees? Properly Reporting Partner Compensation*, Tax Advisor, Nov. 2013.
 - J. Leigh Griffith, *Partners and W-2 Employee Status*, TAXES The Tax Magazine (February 2015).

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