SUTHERLAND

LEGAL ALERT

January 19, 2010

Tennessee Add-Back Assessments - Taxpayers May Need to Act Soon to Preserve Appeal Rights

Introduction

The Tennessee Department of Revenue ("Department") recently sent notices of assessment to numerous taxpayers disallowing deductions for intercompany intangible expenses. The Department states in the notices that it is adding back the expenses because the deductions lack "business purpose." Many of these notices were dated December 18, 2009[1] which is important because taxpayers that received an assessment have only 30 days to request an informal conference. For some taxpayers, the request for an informal conference must be filed by today, January 19.

If a taxpayer timely files a request for an informal conference, the Department must schedule the conference within 20 days of the request, and the Department must hold the conference within 90 days of the request.[2] The informal conference is held by a Department conferee. Following the conference, aggrieved taxpayers may appeal the matter to the Tennessee Chancery Court.[3] If an informal conference is not timely requested, taxpayers that wish to challenge the assessment can either pay the assessment and file a refund claim or file suit in Chancery Court within 90 days of the mailing date of the assessment.[4]

Background

For Tennessee excise tax years beginning on or after January 1, 2004, Tennessee taxpayers who deduct intercompany intangible expenses must disclose those expenses to the Department.[5] If the expenses are not disclosed, the deductions must be added back to calculate Tennessee net earnings.[6] Following the enactment of these disclosure (or addback) requirements, some taxpayers requested guidance from the Department as to the deductibility of their intercompany intangible expenses. In Tennessee Letter Rulings 06-28 and 06-35, the Department was asked whether two taxpayers were permitted to take a deduction for payments made to affiliates for expenses related to the licensing of intangibles.[7] The

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[1] In Tennessee, assessments must be issued three years from December 31 of the year the tax return was filed; thus these assessments were mailed just before the expiration of the assessment period for 2005 returns Tenn. Code § 67-1-1501.

[2] Tenn. Code § 67-1-1801(c)(3).

[3] Tenn. Code § 67-1-1801(a)(1)(B).

[4] Tenn. Code § 67-1-1801. At any time prior to the filing of suit by the taxpayer, the commissioner, in the commissioner's discretion, may hold informal conferences without the requirement of a timely written request for the conference. Tenn. Code § 67-1-1801(c)(3).

[5] Tenn. Code § 67-4-2006(d)(1). The disclosure requirements only apply to intangible expenses, and not interest expenses.

[6] Tenn. Code § 67-4-2006(d)(1).

[7] *See e.g.* Tennessee Letter Ruling 06-28 (07/20/2006); Tennessee Letter Ruling 06-35 (09/22/2006).

Department relied on the *Syms*[8] and *Sherwin-Williams*[9] cases from Massachusetts to inform its analysis. Based on these cases, the Department outlined eight factors it considers in determining whether a taxpayer may deduct payments it makes for the licensing of intangibles:

1. The nature of the intangible property and how it is used;
2. The method by which the taxpayer transferred its patents, trademarks, franchise rights, or other intangibles to its subsidiary;
3. The existence of formal legal agreements between the parties that govern both the transfer and the use of the intangibles;
4. The method by which the value of the intangibles transferred was established;
5. Whether actual cash was exchanged in the relevant transactions;
6. Whether the company holding the intangibles has property and payroll in its state of domicile;
7. Whether corporate forms were established with regard to relevant transactions and whether the corporate requirements and formalities are being met; and
8. Whether there are practical economic effects resulting from the transaction aside from tax planning.[10]

In both rulings, the Department concluded that the taxpayer was permitted to deduct intercompany royalty expenses because the transactions served a valid business purpose aside from generating tax benefits and there was a reliable method of calculating the value of the payments for the licenses.

SUTHERLAND OBSERVATION: Taxpayers challenging an assessment should be prepared to provide evidence to the Department of how their transactions compare to those discussed in the letter rulings issued by the Department and the facts of the *Syms* and *Sherwin-Williams* cases. However, even if these factors cannot be satisfactorily met, there is no Tennessee case law on point regarding the appropriateness of intercompany payments. Thus, taxpayers should consider their facts and the uncertain state of Tennessee law in determining whether to appeal.

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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[8] *Syms Corp. v. Commissioner of Revenue*, 765 N.E.2d 158 (Mass. 2002).

[9] *Sherwin-Williams Company v. Commissioner of Revenue*, 778 N.E.2d 504 (Mass. 2002).

[10] Tennessee Letter Ruling 06-28 (07/20/2006); Tennessee Letter Ruling 06-35 (09/22/2006).

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