



Informal Conference Summaries: FY2018 Administrative Hearing Office

Administrative Hearing Office - Mission and Role

The Tennessee Department of Revenue (the "Department") has an Administrative Hearing Office (the "Hearing Office") where taxpayers can work with informal conference personnel to resolve disputes about tax assessments and tax refund claim denials. Hearing Office personnel are required to exercise independent judgment and render decisions on individual issues based on the facts and the law. The Hearing Office is currently comprised of four hearing officers, all of whom are licensed attorneys with significant tax experience, and a legal assistant with an extensive state tax background.

The Hearing Office's mission is to resolve disputes on behalf of the Commissioner of Revenue in an informal, expeditious, consistent, and cost effective manner. The Hearing Office may also make determinations about the correct amount of tax due. To that end, the Hearing Office conducts informal conferences with taxpayers to discuss their legal positions, ask questions, request additional information or documentation, and make a determination as to how the dispute should be resolved.

In fiscal year 2018, the Hearing Office received over 1,100 requests for informal conferences. Information and frequently asked questions about the informal conference process are available on the Department's website at <http://www.tn.gov/revenue/article/request-an-informal-conference>.

Conferences Held in Fiscal Year 2018: Topics of Interest

The Department has selected several topics of interest summarized below. Each topic of interest also includes overviews of related conference decisions issued over the past fiscal year.

Please be aware that Tennessee law protects the identity and information of individual taxpayers. The Department is required by law to maintain a taxpayer's information as confidential, unless the taxpayer gives the Department permission to disclose information. The unauthorized disclosure of taxpayer information is a criminal offense.

Because the Department takes taxpayer confidentiality very seriously, the following summaries of conference decisions do not contain any details that could lead to an individual taxpayer being identified.

Please also be aware that the summaries are of actual cases and the applicable law might have changed since the conference decision was issued. Furthermore, each case is based upon the facts and circumstances presented, some of which may have been pertinent to the decision but not included in the summary below for confidentiality concerns. Therefore, taxpayers should consult with a tax professional before relying on any information contained in the following summaries.

Personal Liability for Taxes (Tenn. Code Ann. § 67-1-1443)

One reason for operating a business in the form of a corporate or other limited liability entity is to avoid personal liability for the business' liabilities. This protection from liability is not complete, however. So-called "trust fund taxes" are taxes collected on behalf of the government and are an exception to the protections provided by corporate or other limited liability structures.

Individuals who are required to collect and remit tax collected from customers, such as sales tax, may be personally liable for any sales tax collected but not remitted (plus associated penalties and interest),¹ if those individuals had the authority to determine which creditors would be paid and voluntarily chose not to remit the collected taxes to the Department. When a business has failed to remit taxes collected from its customers, the Department's Collection Services Division will first attempt to collect the tax from the business, but if that effort is unsuccessful, it will attempt to identify officers or employees responsible for collecting sales tax and issue proposed assessments to those people individually. In addition to holding conferences about a business' underlying tax liability, the Hearing Office hears challenges to proposed personal tax assessments.

Examples:

The Hearing Office abated a proposed personal liability assessment against a family member who was listed as the owner, president, and only person with signature authority of a business. The documentation provided by the family member allowed the Hearing Office to conclude that the family member was not the individual responsible for overseeing the business' "back office" operations, including collecting taxes from customers or preparing its tax returns.).

The Hearing Office abated a proposed personal liability assessment against the former owner of a business because the former owner was able to document that he had sold his interest in the business before the business' tax liabilities arose. There was no indication that the former owner had continued to have any involvement in the business after selling his ownership interest to the current owner.

The Hearing Office abated a proposed personal liability assessment against a company's employee who had been responsible for collecting, reporting, and remitting sales tax for tax periods pre-dating the assessment. The employee was able to provide supporting documentation showing he was no longer employed by or affiliated with the business.)

The Hearing Office upheld a proposed personal liability assessment against a business owner even after he sold 75% of his business. Though he sold a substantial portion of the business, and the purchase and sale agreement stated the purchaser was responsible for the business's taxes, he continued managing and operating the business on a day-to-day basis.

The Hearing Office upheld a proposed personal liability assessment against a business owner who ran the daily z-tapes from the store's cash registers because he was responsible for determining what amount of sales would be reported to the Department and subsequently remitted to the Department.

¹ Tenn. Code Ann. § 67-1-1443 (2013).

Successor Liability

After purchasing a business, the buyer may find that in addition to acquiring the business, the buyer has also acquired outstanding tax liabilities of the business. Under Tennessee law, the buyer of the business is considered the seller's "successor, successors, or assigns."

The buyer is required to withhold from the purchase price of the business the amount of unpaid taxes, interest, and penalties, unless the seller has provided a certificate of clearance from the Department stating that no taxes, penalties or interest are due. Alternatively, the seller can provide the buyer with an affidavit stating that it has no past due tax liability. The buyer must provide the affidavit to the Department to be protected from liability by the seller's affidavit. The Department has 15 days to notify the buyer if the affidavit is incorrect.

Examples:

The Hearing Office upheld a proposed assessment against a company that purchased another company that had substantial tax liabilities. The Hearing Office determined that the purchaser could not rely on the purchase money paid limitation because the purchase was not done in good faith and for full and adequate consideration. But instead, the purchase of the otherwise viable and ongoing business was purchased for its forced liquidation value that did not include all of the business's assets.

The Hearing Office upheld a proposed successor liability assessment against an individual that took over a convenience store run by his wife as a sole proprietor. After the sole proprietor incurred sales and business tax liabilities, she closed her sole proprietorship's account and her husband opened new accounts while he continued to run the store. The Hearing Office determined that there was no evidence showing that the husband paid adequate consideration in good faith to his wife; therefore he was liable as the successor.

The Hearing Office adjusted a proposed assessment against the purchaser of a convenience store/gas station that only purchased the seller's stock of goods. The purchaser bought the business in good faith and for full and adequate consideration; therefore the tax liability was limited to the purchase price opposed to the seller's full tax liabilities.

Lack of Records

Tennessee law requires dealers to keep adequate books and records of sales and purchases for three years from December 31 of the year in which the associated return was filed so the Department can verify returns and determine a dealer's tax liability.² If an assessment was made and a taxpayer challenges the assessment, either to the Department or in court, the taxpayer must keep all records covered by the assessment until the matter is resolved.³ If a taxpayer fails to keep sufficient records, the Department may make an assessment using the best information available.⁴

² Tenn. Code Ann. § 67-6-523(a, b) (2013) and Tenn. Code Ann. § 67-1-113 (2013).

³ TENN. COMP. R. & REGS. 1320-05-01-.80(2).

⁴ Tenn. Code Ann. § 67-1-113(b) (2013).

When a taxpayer has not kept adequate records, auditors will examine available third-party information such as the taxpayer's purchases, bank deposits and federal tax returns. Auditors often must perform a purchase markup audit, which involves applying a percentage markup to the taxpayer's purchases, to calculate taxable sales. Unless a taxpayer can furnish documentation that was unavailable during the audit, the Hearing Office has no basis on which to make an adjustment.

Examples:

Tennessee taxes sales that occur in Tennessee but does not tax sales by Tennessee sellers that occur outside the state. The Hearing Office upheld a proposed assessment that included tax on sales that a store claimed were exempt out-of-state sales where the store had no documentation showing that the items were shipped outside the state, but allowed the store to obtain statements from non-Tennessee customers to the effect that the items had been shipped to their out-of-state addresses.

Dealers making tax-exempt sales are required to properly document those sales by keeping exemption certificates from customers on file or the dealer will be liable for the tax due on the sales. The Hearing Office reduced a proposed assessment after an equipment dealer provided agricultural exemption authorizations from various farmers and nurserymen⁵ because these sales qualified for the exemption.

Rejecting a convenience store's argument that its bank deposits and credit card sales would be a more accurate reflection of the store's sales, the Hearing Office upheld a proposed sales tax assessment against the store based on the auditor's calculation of the store's sales by marking up the store's purchases. There was no way to segregate fuel sale revenues from other revenues, the store paid some vendors using cash from the cash register, and there was no way to confirm that the store deposited all cash it received into the bank.

The Hearing Office approved the auditor's use of bank deposits to calculate a store's sales and upheld the resulting proposed sales tax assessment. Bank statements were the only records that the store provided other than a sales summary that the store's owner prepared; the owner did not furnish any of the underlying documentation to verify the amounts included in the summary.

Consumer Use Tax

Use Tax is the counterpart to the sales tax. All Tennessee residents, as well as businesses operating in the state, must pay use tax when goods are purchased from outside the state of Tennessee and brought or shipped into the state and the seller did not collect sales tax on the purchase. Purchases made from outside the state include, but are not limited to, mail-order catalog purchases, purchases made online, over-the-phone purchases, and purchases made from a store located in another state. Use tax does not apply to the purchase of services.

Use tax is also due on occasional and isolated sales of items such as aircraft, motor vehicles, trailers, off-highway vehicles, and boats that occur between people who are not motor vehicle or boat

⁵ Tenn. Code Ann. § 67-6-207 (2013).

dealers.⁶ These kinds of occasional and isolated sales are generally subject to sales or use tax. Generally, each time there is a change of ownership that change of ownership results in sales or use tax being due.

Examples:

The Hearing Office upheld a proposed consumer use tax assessment against a man who had purchased an unmanned aircraft system (drone) intending to use it for commercial purposes but who had not yet been licensed to use it by the FAA because it was tangible personal property that was used or stored in Tennessee. The office observed that no exemptions, such as the exemption for farm equipment and machinery, applied to the man's purchase, and he could not receive credit for sales taxes paid to another state because he did not pay sales taxes to another state.

The Hearing Office abated a proposed consumer use tax assessment against a man who had purchased a boat in another state and paid tax based on the price listed in the boat's bill of sale. Although the purchase price was lower than the fair market value, and the seller later provided an affidavit to the Department that was vague about the purchase price, the office found the original bill of sale, which had been signed by both parties with their signatures notarized, to be the more reliable document.

Despite the county clerk's statement that no tax was due when an individual registered a boat in Tennessee, the Hearing Office upheld a proposed consumer use tax assessment on the boat's purchase price because incorrect advice from a government official does not void an otherwise valid assessment. Tennessee courts have consistently held that it is the duty of the Department of Revenue to collect taxes due under state law and the failure of a representative to collect tax does not prevent the Department from assessing or collecting tax due.

The taxpayer, a Tennessee resident, purchased a helicopter from an out-of-state seller. The helicopter was transported to another state where it was parted out. The Department assessed the Taxpayer based upon residency. The Hearing Office abated the assessment because the helicopter was never imported into Tennessee.

When a Montana company purchased an airplane that it hangered in Tennessee for seven years but failed to pay use tax on its purchase, the Hearing Office upheld a proposed assessment of consumer use tax against the company. Because the vast majority of the airplane's flight segments either arrived at or departed from a Tennessee airport and the airplane was stored in Tennessee, the Hearing Office concluded that the company had used the airplane in Tennessee.

A North Carolina company purchased an airplane that it hangered in Tennessee. After reviewing flight logs, the hearing officer determined the assessment was correct on the basis of the aircraft being used in Tennessee. However, the hearing officer adjusted the assessment because the Department failed to give the taxpayer credit for use tax paid in North Carolina.

⁶ Tenn. Code Ann. § 67-6-102 (9)(C) (Supp. 2016).

The Hearing Office upheld a proposed consumer assessment against a man who underreported the purchase price of a boat. The man first claimed to have paid cash and then claimed that he traded equipment for the boat. When he registered the boat, he reported a purchase price was unusually low. Because he did not provide a bill of sale or any other documentation as to the actual purchase price, the Department contacted a boat's previous owner and issued a proposed assessment of tax for the difference between the original purchase price and the amount the man reported he paid.

Hall Income Tax

Persons who are domiciled in Tennessee for at least six months are subject to Tennessee's personal income tax. The Hearing Office abated an assessment where a long-standing Florida resident purchased a vacation home in Tennessee. Though the taxpayers spent four months a year in Tennessee, they did not give up their Florida domicile as they still had a Florida driver's license, Florida voter registration, and other supporting documents evidencing Florida domicile.

The Hearing Office upheld an assessment against a taxpayer even though the taxpayer and its general partner had out-of-state addresses according to organizational documents – both used a Tennessee address on federal and the out-of-state tax returns. Further, the general partner, although formed out-of-state, is managed by a Tennessee resident and all investment decisions were made from Tennessee.

The Hearing Office abated an assessment against a taxpayer related to the inclusion of original issue discount. Although original issue discount is generally subject to the Hall tax, such interest must be accrued, credited or received before it becomes taxable. In this case, the security underlying the original issue discount had incurred substantial loss, therefore no payments were accrued, credited, or received by the taxpayer.

The Hearing Office abated an assessment against a taxpayer where the taxpayer received what was determined to be a nondividend distribution. The taxpayer owned stock in a company that spun-off a higher performing portion of the company. As the result of this spin-off, the taxpayer exchanged its stock in the company for stock in the new spin-off. Because this distribution of stock does not meet the definition of a dividend, the assessment was abated.

Sales Tax

The Hearing Office conducts conferences on a wide variety of sales and use tax issues. Below are examples of some topics the office addressed in conference in FY 2018.

Examples:

Just as sales tax is due on sales of tangible personal property, sales tax is due on lease payments from the rental of tangible personal property. The Hearing Office upheld a proposed sales tax assessment against a business that rented equipment to an affiliate and received checks labeled "lease payments" from the affiliate, despite the business's claim that the lease payments exceeded the fair market rental value of the equipment. There was no written agreement between the business and the affiliate or any documentation other than the checks showing the arrangement between the parties.

Tips are considered part of the sales price of food or beverages if the tips are mandatory unless a restaurant or bar can show that payment of such a tip was not required. The Hearing Office upheld a proposed assessment where a club automatically added a 20% gratuity to its members' checks and the auditor's review of a sample of guest checks showed no instances where the automatic gratuity was reduced or removed.

The Department assessed a veterinarian who was paying sales tax on its purchases of various drugs opposed to charging its customers sales tax. The Hearing Office reviewed the drugs at issue and made numerous adjustments to the assessment by determining that many of the drugs sold by the veterinarian met the definition of "drug" in Tenn. Code Ann. § 67-6-102(33) (2013). Because they met the statutory definition, the veterinarian correctly paid sales tax on its purchases.⁷

Services, parts, accessories, materials, and supplies are exempt from tax when they are used to repair vessels and barges that are principally in interstate commerce. The Hearing Office abated a portion of a proposed assessment against a seller of marine parts to customers where the customers used those parts to repair qualifying vessels and barges.

The Hearing Office upheld an assessment against a city tour company who claimed they did not have to charge sales tax because they were furnishing equipment with an operator, thus a non-taxable service. The Hearing Office determined that the assessment was proper because the company was providing a taxable amusement under Tennessee sales tax rule 117.

The taxpayer filed a claim for refund stating that it resold various construction materials, specifically windows. The Department denied the claim for refund stating that the sales were to contractors, as defined in Tenn. Code Ann. § 67-6-209 (2013), and thus not for resale. The Hearing Office reviewed the taxpayer's documentation and determined that the contractors were in fact reselling the windows, thus granted the refund.

Business Tax

The Hearing Office conducts conferences on a wide variety of business tax issues. Below are examples of some topics the office addressed in FY 2018.

Examples:

The Hearing Office upheld an assessment against a taxpayer who claimed it was exempt from the business tax because the majority of its receipts were from collecting and passing-through insurance payments. The hearing officer determined that only part of the taxpayer's gross receipts were from pass-through insurance payments. Though those receipts were exempt from the business tax, receipts from other taxable services, including performing title searches and providing commercial real estate loan services were subject to the business tax.

Businesses are also taxed at different rates depending on whether they are making wholesale or retail sales. The Hearing Office upheld a proposed business tax assessment against the seller of

⁷ See Tenn. Code Ann. § 67-6-351 (2013).

building products and supplies who had reported its sales at the lower wholesale rate. The seller primarily made sales to contractors, who were considered the users and consumers of the products and supplies they purchased because they were not reselling the materials but were using them to make improvements to realty. Consequently, the sales were retail sales and subject to business tax at the retail rate.

The taxpayer was doing business from multiple locations in the State of Tennessee. The Department assessed the taxpayer for state and city tax at each of its locations. The taxpayer argued that it did not owe city tax in various locations because the cities at issue did not have a business tax. The Hearing Office reviewed the locations and adjusted the assessment, agreeing with the taxpayer that various locations were not subject to a city business tax.

Despite the fact that the taxpayer had receipts from lending money, and therefore felt it was exempt from business tax, the Hearing Office upheld an assessment because the taxpayer also had receipts from other sources. In addition to traditional interest income exempt under Rule 48, it also received income from operational leases, which is non-interest income. For this reason, the Hearing Office upheld the assessment.

The taxpayer owned and operated truck weighing stations in the State of Tennessee. The taxpayer argued that it did not have a physical presence in Tennessee, and thus was not subject to business tax. Although the Hearing Office disagreed with that contention, the Hearing Office abated the 25% delinquency penalty using the good and reasonable cause standard.

The Taxpayer provided in-home non-medical personal care services such as grocery shopping, meal preparation, sitter services, and light housekeeping. The Taxpayer claimed that its services were exempt from business tax as an allied health-services provider. The Hearing Office upheld the business tax assessment finding that the taxpayer's services did not qualify under the allied health services exemption by referencing the Standard Industrial Classification Manual. Because the taxpayer's services did not meet any of the exempt allied health classifications/activities under the Manual, the assessment was upheld.

The Taxpayer sold original equipment manufacturing products to manufacturers who incorporated said products into production machinery used in the manufacturing process. The audit division assessed the taxpayer at the retail rate. The taxpayer reported tax at the wholesale rate, stating that the goods were industrial materials used for future processing, manufacture, or conversion into articles of tangible personal property for resale, thus asserting that they fit the definition of wholesale sale. The Hearing Office upheld the assessment stating that parts in equipment used to manufacture products are used by the manufacturer and not incorporated into the finished product, and thus a retail sale.

Franchise and Excise Taxes

A corporation, limited partnership, limited liability company, or business trust chartered/organized in Tennessee or doing business in this state must register for and pay franchise and excise taxes. The franchise tax is based on the greater of net worth or the book value of real or tangible personal property owned or used in Tennessee. The excise tax is based on net earnings or income for the tax year. The Hearing Office addressed a number of franchise and excise tax issues during FY 2018.

Examples:

As a general rule, one company may not deduct the losses of a predecessor company as the result of mergers, consolidations, and similar transactions, but there is an exception when the predecessor company merges out of existence into a successor that had no income, assets, liabilities, equity, or net worth.⁸ The Hearing Office upheld a proposed franchise and excise tax assessment against a company into which a predecessor merged because the successor company was already in existence and had income, assets, liabilities, equity, and net worth prior to the merger.

In three cases, the Hearing Office upheld proposed franchise and excise tax assessments against companies that had sold their businesses and failed to treat their gains as business earnings⁹ subject to excise tax. Business earnings may arise from transactions and activity in the regular course of a taxpayer's business (the transactional test) or from the disposition of property that constituted an integral part of the taxpayer's regular trade or business operations (the functional test). In all three cases, the Hearing Office agreed that the sale of the companies' businesses did not occur in the normal course of business, but it found that the companies had sold assets that were integral to their businesses. Accordingly, the gains from the sales qualified as business earnings under the functional test.

The taxpayer underwent an F reorganization whereby a new entity succeeded the taxpayer in business. The taxpayer, however, was assessed tax by the Department. The Hearing Office reviewed the transaction documents, including the date the taxpayer ceased to be doing business in Tennessee, and abated the assessment.

Public Law 86-272¹⁰ prohibits states from imposing tax on a taxpayer's net income when the taxpayer's only business in the taxing state is soliciting sales of tangible personal property in interstate commerce. In two cases, the Hearing Office upheld proposed franchise and excise tax assessments against corporations who solicited sales of the corporations' services in Tennessee, because Public Law 86-272 applies only to solicitations for sales of goods.

The taxpayer filed a final return and requested a refund. The Department reviewed the refund, denied the refund, and determined additional tax was due. The Department stated that the taxpayer improperly calculated its net worth on a consolidated basis and that to file on a consolidated basis the entire affiliated group must be in final return status during the same tax period. The Hearing Office reviewed the transaction, abated the assessment, and granted the refund stating that even though some of the entities in the affiliated group were not filing final returns, they were disregarded to the ultimate parent entity that was in final return status; therefore they were properly included in the consolidated net worth calculation on the consolidated return.

⁸ Tenn. Code Ann. § 67-4-2006(c)(3) (Supp. 2016).

⁹ Tenn. Code Ann. § 67-4-2004(4) (Supp. 2016).

¹⁰ 15 U.S.C.A. § 381(a).

When calculating the actual value of real or tangible property to determine a taxpayer's franchise tax base, a taxpayer is required to include the value of rental property based upon a multiple of the net annual amount of rent paid.¹¹ The Hearing Office upheld a proposed franchise and excise tax assessment where the Department added amounts that a restaurant paid to the owner of the property where it operated, despite the fact that the restaurant sometimes labeled the payments as a management fee instead of rent. There were no written agreements between the restaurant and the property owner and no documentation of any services that the property owner performed for the restaurant.

As a general rule, a taxpayer's franchise tax liability is based on what the taxpayer reports on its federal tax return. The Hearing Office adjusted a proposed franchise tax assessment where a corporation demonstrated that it erroneously included a tract of property it had sold three years earlier on its federal balance sheet; the property was removed from the taxpayer's franchise tax base.

Miscellaneous other taxes

In addition to the tax categories discussed above, the Hearing Office occasionally conducts conferences where the tax type is one that is less frequently seen. Below are some examples of topics the office addressed in FY 2018.

Examples:

The professional privilege tax is on the privilege of maintaining an active license with certain professional licensing boards¹² and is due on June 1 of each year. The Hearing Office upheld a proposed professional privilege tax against an attorney whose Tennessee license was suspended three months after the June 1 deadline and who had not practiced in Tennessee for two years. Under Tennessee case law, as long as a license is active, the profession privilege tax is due regardless of whether the license holder is practicing in Tennessee. The office further found good and reasonable cause to waive the associated penalty.

Tennessee imposes a privilege tax on anyone manufacturing and selling or importing and selling bottled soft drinks within Tennessee.¹³ The taxpayer (an in-state) distributor argued that the manufacturer should be liable for the bottlers tax. The Hearing Office rejected this argument because the manufacturer did not have nexus in Tennessee and the bottlers tax provides that when the manufacturer does not have nexus, the tax can then be imposed on the in-state importer or distributor.

¹¹ Tenn. Code Ann. § 67-4-2108(a)(3) (2013).

¹² Tenn. Code Ann. § 67-4-1701 *et seq.* (2013).

¹³ Tenn. Code Ann. § 67-4-402(b) (2013).

Conclusion

In addition to the above information and summaries, a wealth of tax information is available on the Department's website found at <http://www.tn.gov/revenue/>. The "contact us" link at the bottom of the page provides links to telephone numbers for the general call center, as well as telephone number hotlines associated with specific tax areas. Questions may also be submitted in writing by clicking on the "Help" button on the Department's home page.