TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 22-03

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

Applicability of the Tennessee franchise tax add-back requirement for short-term intercompany trade payables.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

(A) The taxpayer must not have misstated or omitted material facts involved in the transaction;

(B) Facts that develop later must not be materially different from the facts upon which the ruling was based;

(C) The applicable law must not have been changed or amended;

(D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and

(E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] (the "Taxpayer") is a [REDACTED] corporation that does business as [REDACTED]. The Taxpayer manufactures, assembles and sells [PRODUCTS]. Nearly all the Taxpayer's products are manufactured and assembled at affiliated plants in [REDACTED].

The Taxpayer conducts operations within the United States through its [REDACTED] US Branch (the "U.S. Branch"), which is domiciled in [REDACTED]. For federal income tax purposes, the Taxpayer reports the activity of its U.S. Branch on IRS Form 1120-F (United States income tax return of a foreign corporation). The U.S. Branch serves primarily to ensure that the products of the various business groups flow smoothly from the Taxpayer to customers in North and South America; specifically, it provides administrative control and coordination with Taxpayer's major customers in the United States.

When a customer in the United States places an order for a product, the U.S. Branch purchases the inventory from an affiliate of the Taxpayer (the "Affiliate"). This process creates a short-term intercompany trade payable (the "Trade Payable") based on an executed Advance Pricing Agreement with the Internal Revenue Service (the "IRS").[1] The Advance Pricing Agreement establishes an appropriate "arm's length," or "third-party" price for the inventory purchased by the U.S. Branch from the Affiliate.[2] The Trade Payable is settled on a monthly basis.

The Trade Payable owed by the U.S. Branch to the Affiliate is reported as a short-term or current liability on the Taxpayer's balance sheet and is reflected likewise on Schedule L of the federal Form 1120-F. The Taxpayer files its Tennessee franchise and excise tax return on a separate entity basis and reports the activity of the U.S. Branch. Currently, the Taxpayer adds back the Trade Payable in arriving at its net worth when calculating its franchise tax liability.[3]

RULING

Is the Taxpayer required, in accordance with TENN. CODE ANN. § 67-4-2107(b)(1) (2013), to add back a short-term intercompany Trade Payable owed by the U.S. Branch to the Affiliate for purposes of calculating the Taxpayer's Tennessee franchise tax liability?

> Ruling: No. The Taxpayer is not required to add back a short-term intercompany Trade Payable owed by the U.S. Branch to the Affiliate.

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[1] A Trade Payable is generally defined as an amount billed to a company by its suppliers for goods delivered to or services consumed by the company in the ordinary course of business. *See e.g.,* Trade Payables, *The Law Dictionary*, https://thelawdictionary.org/trade-payables/ (last visited March 14, 2022); Trade payable definition, *AccountingTools*, https://www.accountingtools.com/articles/2017/5/15/trade-payable (last visited March 14, 2022); What are Trade Payables, *Simple-accounting*, https://simple-accounting.org/what-are-trade-payables-definition-and-explanation/ (last visited March 14, 2022).

[2] The facts herein assume that an appropriate "arm's length," or "third-party" price is established by the Advanced Pricing Agreement. The ruling solely addresses whether the Trade Payable is subject to the add-back requirement.

[3] The Taxpayer has not made an election to compute net worth on a consolidated basis.

ANALYSIS

Under TENN. CODE ANN. § 67-4-2107(b)(1), debt that a corporation owes to an affiliate corporation must be added back to its franchise tax base calculation if its capital stock is inadequate for its business needs. Relatedly, TENN. COMP. R. & REG. 1320-06-01-.15 ("Rule 15") governs the amount of affiliated debt that must be included in a corporation's franchise tax base.

In *Exxon Mobil Corp. v. Johnson*, the court found that the purpose of the statute is to prevent thinly capitalized or poorly capitalized companies that obtain an infusion of capital from an affiliated corporation from classifying such infusion as debt rather than equity, thereby avoiding the franchise tax.[4] Additionally, the court in *Exxon* found that Rule 15 is only applicable in certain limited situations. In light of the purpose of the statute, the Tennessee Department of Revenue (the "Department") takes the position that account or trade payables that are current liabilities are not considered affiliated debt.

Here, the Trade Payable owed by the U.S. Branch to the Affiliate is settled on a monthly basis. GAAP defines current liabilities as "obligations that are reasonably expected to be liquidated within one year."[5] Because the Trade Payable is settled monthly, it appears that the Taxpayer appropriately classifies it as a current liability for financial reporting purposes. Under the Department's position that trade payables that are current liabilities should not be treated as affiliated debt, the add-back provision of TENN. CODE ANN. § 67-4-2107(b)(1) does not apply to the Trade Payables in question.

APPROVED: David Gerregano
Commissioner of Revenue

DATE: May 4, 2022

[4] No. 97-1112-II, 20 (Davidson Cnty. Ch. Ct. Sept. 17, 2002).

[5] ARB 43: Restatement and Revision of Accounting Research Bulletins, Chapter 3, Section A(7) (June 1953).