

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

BDO KNOWS:

SALT



SUBJECT

TENNESSEE DEPARTMENT OF REVENUE ISSUES FINAL FRANCHISE AND EXCISE TAX MARKET SOURCING REGULATIONS

SUMMARY

On June 28, 2016, the Tennessee Department of Revenue filed final Franchise and Excise Tax regulations with the Secretary of State to assist with the implementation of Tennessee's switch to market sourcing (Rule 1320-06-01-.42). The regulations apply to taxable years beginning on or after July 1, 2016, but do not become effective until September 26, 2016 (90 days after filed with the Secretary of State as per the Tennessee Administrative Procedures Act, T.C.A. § 4-5-207).

DETAILS

Background and General Sourcing Framework

Tennessee abandoned the costs of performance method for assigning sales of services and licenses and sales of intangibles for Franchise and Excise Tax purposes in favor of market sourcing upon enactment of the Revenue Modernization Act of 2015 in June 2015. See [BDO SALT alert](#). Pursuant to that law, for taxable years beginning on or after July 1, 2016, Tennessee generally assigns sales of services to Tennessee to the extent the service is delivered to a location in the state, and licenses and sales of intangibles to the extent the intangible property is used in the state.

The regulations, which are based on the model regulations issued by the Multistate Tax Commission ("MTC"), even though those model regulations (the "MTC Model") remain a "working draft" and have not been adopted by the MTC's Executive Committee in final form, follow the MTC Model's hierarchy approach to sourcing services. As such, the regulations apply a complicated set of cascading sourcing rules, distinguish between in-person services, professional services, and services delivered to, or on behalf of, or through a

CONTACT:

ATLANTIC:

JONATHAN LISS, Tax Senior Director
215-636-5502 / jliiss@bdo.com

JEREMY MIGLIARA, Tax Senior Director
703-770-0596 / jmigliara@bdo.com

CENTRAL:

ANGELA ACOSTA, Tax Senior Director
248-688-3313 / aacosta@bdo.com

NICK BOEGEL, Tax Senior Director
414-615-6773 / nboegel@bdo.com

JOE CARR, Tax Principal
312-616-3946 / jcarr@bdo.com

MARIANO SORI, Tax Partner
312-616-4654 / msori@bdo.com

RICHARD SPENGLER, Tax Senior Director
616-776-3687 / rspengler@bdo.com

NORTHEAST:

JANET BERNIER, Tax Principal
212-515-5405 / jbernier@bdo.com

MATTHEW DYMENT, Tax Principal
617-239-4130 / mdyment@bdo.com

SOUTHEAST:

TONY MANNERS, STS Senior Director
404-979-7274 / tmanners@bdo.com

ASHLEY MORRIS, Tax Senior Director
919-278-1963 / amorris@bdo.com

SCOTT SMITH, Tax Senior Director
615-493-5629 / ssmith@bdo.com

SOUTHWEST:

TOM SMITH, Tax Partner
918-281-4080 / tasmith@bdo.com

GENE HEATLY, Tax Senior Director
214-665-0716 / gheatly@bdo.com

WEST:

ROCKY CUMMINGS, Tax Partner
415-490-3130 / rcummings@bdo.com

PAUL MCGOVERN, Tax Senior Director
714-913-2592 / pmcgovern@bdo.com

customer, adopt a throw-out rule, and impose documentation requirements on taxpayers to substantiate their sourcing determinations. The new market sourcing regulations also distinguish between marketing and production intangibles. The regulations make extensive use of examples to illustrate the application of Tennessee's market sourcing provisions.

With respect to sales of services, the regulations permit the use of reasonable approximation methods to assign receipts, but generally require reasonable approximation to reflect an effort by the taxpayer to approximate the results that would be obtained under a specific method for the type of service set forth in the regulations. In addition, many of the specific types of services assignment rules provide specific reasonable approximation methods used to source sales where sales may not be reasonably assigned under a higher priority rule.

In-Person Services

The regulations assign sales from the performance of in-person services to the location where the service is delivered in the physical presence of the customer or the customer's property.

Professional Services

Professional services require specialized knowledge, license or degree, and include legal, accounting, management, financial, investment, fiduciary, payroll, data processing, consulting, and engineering services. Tennessee assigns sales of professional services depending on whether they are provided to an individual or business customer. In the event there is an overlap between an in-person service and a professional service (e.g., medical or dental services), then the in-person services sourcing rules apply, except with respect to legal, accounting, financial, and consulting services for which the professional services sourcing rules apply.

Professional services provided to an individual - The regulations assign sales of professional services provided to an individual to the individual's primary residence, or, if the service provider does not have information regarding the customer's primary residence, then to the customer's billing address. However, a taxpayer that derives more than 5 percent of its sales of services from a customer must assign the sales to that customer to the customer's state of primary residence.

Professional services provided to a business - The regulations assign sales of professional services provided to a business customer according to the following hierarchy: first, to the place where the contract of sale is principally managed by the customer; then to the customer's place of order if the sales have not been assigned; and, if the sales still have not been assigned, then to the customer's billing address. However, similar to where the customer is an individual, a taxpayer that derives more than 5 percent of its sales of services from a customer must assign the sales to that customer to the state where the contract of sale is principally managed by the customer.

Professional services billing address safe harbor - The regulations provide a billing address safe harbor for sales of professional services that may be utilized to assign sales of professional services, regardless of the rules discussed above. Specifically, sales of professional services may be assigned to customer billing addresses if the service provider engages in substantially similar services with more than 250 customers, and does not derive more than 5 percent of its sales from that customer. Accordingly, if a customer accounts for more than 5 percent of the service provider's sales, then the billing address safe harbor cannot be used to assign sales to that large-volume customer.

Architectural, broadcasting advertising and engineering services - The regulations provide special sourcing provisions for architectural, broadcasting advertising, and engineering services. Specifically, the regulations assign sales of architectural and engineering services provided with respect to tangible personal property or real estate improvements to the state(s) where and to the extent the property is or expected to be located. A television broadcast network, cable program network, or television distribution company that sells advertising services to a broadcast customer assigns sales to the customer's state of commercial domicile.

Services Delivered To or On Behalf of a Customer, or Delivered Electronically Through the Customer

With respect to sales of services delivered to or on behalf of a customer, or delivered electronically through the customer, the regulations distinguish between business and individual customers. A taxpayer that cannot reasonably make this determination must treat the customer as a business customer.

Services delivered to or on behalf of a customer by physical means - The regulations assign sales of services delivered to or on behalf of a customer by physical means to the location where the service is physically delivered to the customer, or to a third-party on behalf of the customer. If the actual delivery location is unknown, then it may be approximated.

Services delivered electronically to an individual customer - The regulations assign sales of services that are delivered electronically to an individual customer to the location where the service is actually received. If the actual location of receipt is unknown or cannot be reasonably estimated, then the sale is assigned to the customer's billing address.

Services delivered electronically to a business customer - The regulations assign sales of services delivered electronically to a business customer to the location where the service is directly used by the customer's employees or designees. Under a "secondary rule of reasonable approximation" sales are assigned according to the following hierarchy: first, to where the contract of sale is principally managed by the customer; then to the customer's place of order; and, if the sale has still not been assigned, then to the customer's billing address. A similar billing address "safe harbor" (and same large-volume customer exclusion) that may be applied for assigning sales of professional services also applies to services delivered electronically to a business customer.

Services delivered electronically through or on behalf of a customer - The regulations apply a "look-through rule" to sales of services delivered electronically through or on behalf of a customer, and assign such sales to the state of the customer's end users or third-party recipients (i.e., the customers of the customer). If a taxpayer cannot determine the state(s) in which the services are actually delivered to end users or third-party recipients, a reasonable approximation method may be used to assign the sales. In addition, under an "intermediary rule," if a service is delivered to a customer that acts as the taxpayer's intermediary in reselling the service to end users or other third-party recipients, and the taxpayer lacks information to determine or reasonably approximate the end users' locations, then the taxpayer must use a population ratio based on the state's population in the specific geographic area in which the intermediary resells the service to assign sales. A similar rule applies where the taxpayer's service is the direct or indirect electronic delivery of advertising on behalf of its customer to the customer's intended audience.

Software Transactions

The regulations treat prewritten software for purposes of other than commercial reproduction as tangible personal property when delivered on a tangible medium, and generally apply the traditional "destination state" assignment rule applicable to sales of tangible personal property to assign sales therefrom. In all other software transactions, including electronically-delivered software, the regulations apply the rules applicable to services (e.g., custom software), the license of a marketing intangible, or the license of a production intangible, depending on the facts.

Digital Goods and Services

The regulations assign sales and licenses of digital products according to the rules for assigning sales of services delivered electronically to, or through or on behalf of, a customer, including the "look-through rule."

Licenses of Intangibles

The regulations assign royalties and license fees from intangibles according to the sourcing methodologies in the following chart:

INTANGIBLE PROPERTY TYPE	SOURCING METHODOLOGY
Marketing intangibles (e.g., trademarks and service marks)	Assigned to each state to the extent attributable to the sale of goods, services, or other items in the state
Production intangibles (e.g., patents, copyrights, and manufacturing trade secrets)	Assigned based on where they are used in the production process
Mixed intangibles	Assigned based on the license agreement if royalty or license fees are reasonably and separately established for each intangible component. Otherwise, a mixed intangible is treated as a marketing intangible.
Intangibles licensed as part of the sale or lease of tangible property	Apply the provisions that relate to the sale or lease of tangible property
Intangibles that resembles a sale of goods or services	Apply the provisions that relate to services delivered electronically to, or through or on behalf of, the customer

Sales of Intangibles

If a sale of an intangible resembles a license or the sale of goods and services, the intangible licensing sourcing rules discussed above apply. Otherwise, except for intangibles that authorize business activity in a specific geographic area, sales of intangibles are excluded from the sales factor, including sales of goodwill, partnership interests, and covenants not to compete.

Throw-Out Rule

If the taxpayer cannot determine the state(s) of assignment of a sale based on the rules set forth in the regulations using a reasonable amount of effort, including the use of a reasonable approximation method, then the regulations require the taxpayer to exclude the sale from the numerator and denominator of the apportionment factor.

Documentation and Retention of Contemporaneous Records

As a taxpayer proceeds through its assignment determinations, the new regulations, like other states that adopted the MTC Model, require the taxpayer to make a good faith and reasonable effort to apply the applicable assignment rule under the hierarchy. Further, a taxpayer must document the basis for its determination that a higher priority rule did not apply in favor of applying a lower priority rule in the sourcing hierarchy. A taxpayer must also retain contemporaneous records that explain the determination and application of its method of assigning sales.

Ability of Taxpayer to Change Method of Services Receipts Sourcing

The Tennessee regulations provide that a taxpayer's method of assigning sales must be applied consistently with respect to similar transactions from year-to-year.

BDO INSIGHTS

- ▶ Since market sourcing goes into effect for the Tennessee Franchise and Excise Tax for taxable years beginning on or after July 1, 2016, taxpayers have some time to consider the impact that the new Tennessee market sourcing regulations will have on them for tax reporting purposes, as well as the data that they will need to gather and evaluate to make their sourcing determinations. Regardless, however, since the new regulations and market sourcing are effective for taxable periods beginning on or after July 1, 2016, Tennessee taxpayers should assess what, if any, impact these regulations may have on their existing deferred tax balances for financial reporting purposes, and adjust accordingly as of the enactment date.
- ▶ Given the requirement to consistently apply a sourcing methodology year-to-year, taxpayers should take deliberate steps as part of a defined process of making sourcing determinations under the new Tennessee regulations. For this reason, taxpayers should consider developing a fact-specific market sourcing study tailored to each of their revenue streams and markets, and substantiate with relevant books and records, including contracts and other factual data to support the underlying sourcing determinations. Under certain circumstances, receipts and other sourcing data collection, systems, and procedures may need to be modified to comply with the due diligence requirements being imposed by Tennessee.
- ▶ The new Tennessee market sourcing regulations represent just one of several “models” being applied by different states that have also recently switched from sourcing services and intangibles receipts from the traditional costs of performance method to the market sourcing method. As a result of varying state approaches and complexities among the states, there is a significant risk for inconsistent and duplicative sales sourcing results for multistate intangible and services businesses, and, thus, a heightened risk for multiple taxation. Accordingly, multistate service providers, regardless of size, must apprise themselves of the increased sourcing analysis and documentation burden that the new Tennessee market sourcing regulations (and similar administrative rules issued by other states) will have on their tax compliance and tax planning.

The Tax Practice at BDO is among the largest tax advisory practices in the United States. With more than 60 offices and over 500 independent alliance firm locations in the United States, BDO has the bench strength and coverage to serve you.

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through more than 60 offices and over 500 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,408 offices in 154 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information, please visit www.bdo.com.

Material discussed in this tax alert is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.