



Informal Conference Summaries: FY2019 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 three 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 2019, the Hearing Office received 1,998 requests for informal conferences, 1,594 of which were resolved without a conference. Information and frequently asked questions about the informal conference process are available on the Department's website at <https://www.tn.gov/revenue/tax-resources/compliance-information/request-an-informal-conference.html>.

Conferences Held in Fiscal Year 2019: 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 an unpaid sales tax liability, 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:

- In two instances, the Hearing Office abated proposed personal liability assessments against business owners who the Department had believed were required to collect, truthfully account for, and pay over taxes collected from their customers. The owners provided additional information showing that they were not involved in their business's accounting-related activities and did not participate in reporting or remitting taxes, so they had not willfully failed to account for and pay over the taxes.
- The Hearing Office upheld a proposed personal liability assessment against a responsible person associated with a defunct car dealership. The person argued that the assessment against him was outside the three-year statute of limitations during which tax could be assessed. The Hearing Office found the Department had assessed the car dealership for the unremitted taxes within the three-year statute of limitations. The personal liability assessment was valid, because it was a collection action taken within the six years the Department had to collect the tax assessed against the car dealership.
- The Hearing Office abated a proposed personal liability assessment against a company's former officer because he established he had retired before the tax liability was incurred and could not have been a person responsible for collecting, reporting, and paying over those taxes.
- The Hearing Office upheld a proposed personal liability assessment against a man who did not dispute he was the person responsible for collecting and remitting a business's sales taxes. The Hearing Office obtained approval to waive associated penalties because the business had declared bankruptcy and its attorney advised the man not to make any payments while the business was in bankruptcy.

¹ Tenn. Code Ann. § 67-1-1443 (2013).

- The Hearing Office upheld a proposed personal liability assessment against the owner of an accounting firm for taxes owed by a retail store. The Hearing Office agreed that if the accountant had been hired merely to provide accounting services, the accountant would not be personally liable for the store's taxes. However, in this case, the accountant was also an officer of the store, sat on its board of directors, and owned 100% of the store.

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 outstanding tax liabilities. The purchase contract stated the seller was to have filed all outstanding tax returns and fully paid all taxes due. However, the seller did not file the returns and pay the amounts due. The purchaser had not obtained a tax clearance letter and had not filed an affidavit with the Department, and was therefore liable as a successor.
- The Hearing Office upheld a proposed assessment against a former employee who took over a convenience store after the former owner abandoned the premises and the store's inventory. The employee did not purchase the former owner's stock of goods but acquired them at no cost, took over the store's assets, and continued the business as a going concern. Before taking over the store, the employee did not receive a certificate of tax clearance or an affidavit from the prior owner.
- The Hearing Office upheld a proposed assessment against a secured creditor who declared a company's loans in default, sold the company's assets at a UCC sale, and bought those assets at the sale. The Hearing Office upheld the assessment because the secured creditor essentially purchased the assets from itself without obtaining a tax clearance letter or an affidavit from the previous owner.
- The Hearing Office abated a proposed assessment against a company because it had not in fact purchased or merged with another company in a similar line of business. The first company had hired the other company's former owner as a sales representative, who inaccurately had represented his employment as a merger.

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 is 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 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.

In the absence of sufficient records, auditors often must perform a purchase markup audit. This 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 in these cases has no basis on which to make an adjustment.

Examples:

- Credit card payment processors report payment transactions over a certain threshold to the Internal Revenue Service by filing a Form 1099-K. The auditor used a company's 1099-Ks to determine the company's sales and the Hearing Office upheld the resulting proposed assessment based on those sales figures. The only records provided by the taxpayer were incomplete bank statements and a worksheet prepared by the company; the company did not provide any underlying documentation to verify amounts listed on the worksheet.
- The Hearing Office upheld a proposed assessment against a restaurant that did not produce any sales records. The auditor determined the restaurant's sales by examining menu prices and food purchases, calculating average markup percentages for various categories of food, and marking up the food purchases.
- Tennessee taxes sales that occur in Tennessee but does not tax sales by Tennessee sellers that occur outside the state. The Hearing Office adjusted a proposed assessment against a clothing store by removing sales where the store could document that it sold and shipped clothing to an out-of-state retailer.
- Tennessee taxes food and food ingredients at a lower rate than prepared foods and candy.⁵ The Hearing Office upheld a proposed assessment against a grocery store that sold food and food ingredients, as well as prepared foods and candy. The auditor reviewed the taxpayer's z-tapes, which indicated the taxpayer was collecting the higher rate for prepared foods and candy on all sales but reporting food sales on its return at the lower rate. The taxpayers

² Tenn. Code Ann. § 67-6-523(a, b) (2018) 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).

⁵ Tenn. Code Ann. § 67-6-228 (2018).

argued that they had not charged the higher rate on all sales, and that less tax was therefore owed. The Hearing Office upheld the assessments because a review of the taxpayer's z-tapes and sales tax returns confirmed the auditor's review. The taxpayer was collecting 7% on all transactions but remitting tax at the lower rate on food and food ingredient sales. The taxpayer did not have any other documentation to prove it was not collecting sales tax at a higher rate than it was remitting to the Department.

- The Hearing Office upheld a proposed assessment against a restaurant based on the restaurant's financial records, such as bank statements and federal tax returns. The auditor was unable to use records from the restaurant's point-of-sale system because the restaurant had multiple systems and data could not be recovered from some of those systems. In addition, the restaurant had not kept handwritten tickets prepared when servers took customers' orders.

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 Tennessee and brought or shipped into the state and the seller did not collect sales tax on the purchase.⁶ 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 dealers.⁷ These kinds of occasional and isolated sales are generally subject to sales or use tax.

Examples:

- Tennessee allows credit for sales tax rightly paid in another jurisdiction when tangible personal property is purchased.⁸ The Hearing Office upheld a proposed consumer use tax assessment against a woman who imported artwork from outside of the country. The woman believed she had paid tax on her purchase but was unable to document this had occurred.
- The Hearing Office abated a proposed consumer use tax assessment against a man who appeared to have imported furniture into Tennessee. The man proved he had not lived at the address where the furniture was delivered for more than six years.

⁶ Tennessee gives credit for legally imposed sales or use tax paid to another state and the purchaser may claim such payment as a credit against any Tennessee use tax liability. Tenn. Code Ann. § 67-6-507(a) (2018); Tenn. Comp. R. & Regs. 1320-05-01-.91.

⁷ Tenn. Code Ann. § 67-6-102(8)(C) (2018).

⁸ Tenn. Code Ann. § 67-6-507(a) (2018).

- The Hearing Office abated a proposed consumer use tax assessment against a man who imported various electrical components into Tennessee because he was able to document he had returned the items and received a refund.
- Although Tennessee imposes a use tax on items imported into Tennessee, it exempts boats brought into the state by individuals who used to be residents of another state and who move to Tennessee if the boat's fair market value is under \$10,000.⁹ The Hearing Office abated a proposed consumer use tax assessment against a man who brought a boat with a low fair market value into Tennessee after he established he had been a resident of Alabama when he purchased the boat.
- The Hearing Office upheld a proposed consumer use tax assessment against a California resident who purchased materials that were delivered to his father-in-law in Tennessee. Despite the fact that the man did not live in Tennessee, the materials were imported into Tennessee for use or consumption in Tennessee and no tax had been paid in another state, so tax was due on the materials' importation.
- The Hearing Office upheld a proposed consumer use tax assessment against a man who underreported the purchase price of a motorcycle. The man first claimed to have paid an extremely low price for the motorcycle and then signed an affidavit listing the purchase price as a somewhat higher, but still unusually low price. It was not clear from invoices for labor and parts whether the work done was to repair the motorcycle or to customize it. Given the discrepancies and lack of supporting documentation, the Hearing Office agreed that the auditor correctly determined the difference between the reported purchase price and the fair market value of the motorcycle was the proper basis for the tax.
- The Hearing Office abated a proposed consumer use tax assessment based on the difference between a vehicle's fair market value and the considerably lower reported selling price. The seller and the purchaser signed an affidavit of transfer, in which the seller explained the low price was because the vehicle would not start, and the assignment of title on the back of the vehicle's certificate of title also listed the low selling price.

Hall Income Tax

Although it does not tax income from wages, Tennessee imposes the Hall income tax on stock dividends and bond interest.¹⁰ Returns of capital, however, are not subject to tax.¹¹ Tennessee's definition of what constitutes a dividend was crafted by the courts and is quite broad; a dividend is the recurrent payment to stockholders that does not reduce stock holdings leaving owners in a position to enjoy future returns on the same stock and may come from any source. "Stock" can also include some partnership interests.

⁹ Tenn. Code Ann. § 67-6-210(c) (Supp. 2018).

¹⁰Tenn. Code Ann. § 67-2-102 (Supp. 2018).

¹¹ Tenn. Code Ann. § 67-2-104(e)(7) (Supp. 2018).

Through a federal matching program, the Department compares the federal tax returns of Tennessee residents to Hall income tax returns, and it may issue a proposed assessment for taxable distributions that were not reported to Tennessee. Taxpayers in these situations often are not aware that a distribution may be a dividend for Hall income tax purposes even if the distribution is characterized as some other type of income on federal Form 1099.

Examples:

- The Hearing Office upheld the denial of a refund claim filed by a couple who received a revised tax reporting statement listing some of their income as a non-dividend distribution for federal income tax purposes. Tennessee does not rely on federal law to interpret its income tax statutes because the statutory schemes are different. Unlike Tennessee law, federal law requires that a “dividend” be paid from earnings and profits and any distribution from another source is considered a non-dividend distribution.
- The Hearing Office reversed the denial of a refund requested by the owner of Unit Investment Trusts. The trusts were composed of municipal bonds with various maturity or callable dates; as each bond matured, called, or was sold, the original investments were returned to investors and the trusts’ portfolios were reduced. Consequently, these distributions were nontaxable returns of capital.
- Persons who are domiciled in Tennessee for at least six months are subject to Tennessee’s personal income tax. The Hearing Office reversed the denial of a refund claimed by a man who lived in North Carolina. The man was registered to vote and licensed to drive in North Carolina and filed North Carolina individual income tax returns. Although the man’s wife lived and worked in Tennessee, the investments generating the taxable income were not in her name.
- Income from publicly traded real estate investment trusts (REITs) is exempt from Tennessee’s Hall income tax.¹² The Hearing Office adjusted proposed assessments to remove tax levied on publicly traded REIT income.

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 2019.

Examples:

- Tennessee sales tax is levied on sales of tangible personal property and certain enumerated services. The Hearing Office reduced a proposed sales tax assessment against a business that provided monthly memberships to receive various non-taxable personal services. At the end of each session, the taxpayer provided the customer with a free beverage. The auditor issued a sales tax assessment based on the argument that this constitutes a bundled transaction.

¹² Tenn. Code Ann. § 67-2-104(e)(17) (Supp. 2018).

The Hearing Officers reduced the assessment by finding the true object of the transaction was the non-taxable services and not the provision of beverages.

- Parking lot and motor vehicle storage charges are subject to sales tax. The Hearing Office abated a proposed sales tax assessment against a building owner that leased a parking lot to a neighboring company. Because the neighboring company paid rent on a monthly basis instead of a per car basis and the building owner did not have any employees on the premises serving as parking lot attendants, the building owner was renting real property instead of operating a parking lot.
- In two instances, the Hearing Office upheld proposed sales tax assessments where construction businesses purchased agricultural equipment for their owners. The owners of the construction businesses had farms and agricultural exemption certificates. The businesses, which were separate legal entities from their owners, did not have the required exemption certificates when making the purchases and were therefore not entitled to claim the exemption.
- Repairing tangible personal property is one of the services that are subject to sales tax. The Hearing Office upheld a proposed sales tax assessment against a business that repaired household tools and that did not charge and collect tax on those services. Despite the fact the business had not collected the tax, it was still liable for that tax.
- Tennessee allows dealers a credit for sales tax paid on repossessed merchandise. In order to receive the credit, a dealer must sell the property on a security agreement and repossess the item. The Hearing Office upheld a proposed sales/use tax assessment against a used car dealer who transferred its installment contracts to a finance company immediately after each financed sale. The dealer did not qualify for the credit because it could not have repossessed the vehicle, as it no longer owned the contracts.
- Dealers who resell tangible personal property may purchase the property they intend to sell tax-free using a resale certificate. The Hearing Office upheld a proposed sales tax assessment against a used car dealer for tax on GPS devices it had purchased using its resale certificate. The dealership did not offer GPS devices for sale but had purchased and installed the devices so it could track the location of cars to repossess them if the purchaser failed to make payments.

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 2019.

Examples:

- Business tax is imposed on a business's taxable gross sales. The Hearing Office adjusted a proposed business tax assessment against a supermarket chain that had not included rebates from vendors in its gross sales but had treated the rebates as a reduction to its cost of goods

sold. The Hearing Office agreed the rebates were based on the chain's purchases and were not issued to make up the price difference for certain items at a discount.

- Sales from wholesalers to wholesalers are not subject to the business tax. The Hearing Office upheld a proposed assessment against a company that sold trucks to an affiliate who in turn leased the trucks to commercial customers and reported the sales as exempt. The affiliate was not a wholesaler because persons leasing tangible personal property to users or consumers are retailers, not wholesalers.
- Unless they are specifically excluded, sales of services are subject to business tax. The Hearing Office adjusted a proposed business tax assessment against a Tennessee telemarketing company that solicited orders for an out-of-state supply company and received commissions for its sales of services because Tennessee law allows service providers to deduct services delivered to locations outside Tennessee.¹³
- Certain services, such as providers of allied health services as defined by the Standard Industrial Classification index (SIC), are exempt from business tax. Allied health services under the SIC include blood banks, health screening, and dialysis clinics. The Hearing Office upheld proposed business tax assessments against providers of non-medical personal care service providers because the services did not fall within the industries classified as allied health services in the SIC.
- Business tax is levied on income from the rental of tangible personal property and warehousing services but is not levied on income from real property rentals.¹⁴ The Hearing Office upheld a proposed business tax assessment against a warehouse operator despite its claim that it was leasing real property to its customers. In a true lease situation, the tenant is entitled to exclusive possession of the property. In this case, the warehouse was under the operator's possession and control and the customers did not have unlimited access to or control of the warehouse.
- Under Tennessee law, a person acting as a broker or an agent on behalf of another making sales of tangible personal property or services without maintaining a stock of merchandise or taking title to such property owe business tax only on commissions and not the sale price of the goods.¹⁵ The Hearing Office adjusted a proposed business tax assessment against a freight broker by removing freight charges from the broker's business tax base. The broker arranged shipments with third party carriers on behalf of its clients, did not hold itself out as a carrier, and obtained reimbursement for freight charges from its clients. The fees for the broker's facilitation services were the taxable brokerages services.

¹³ Tenn. Code Ann. § 67-4-711(a)(6) (Supp. 2018).

¹⁴ Tenn. Code Ann. §§ 67-4-705 (2013), 67-4-708 (Supp. 2018).

¹⁵ TENN. COMP. R. & REGS. 1320-04-05-.02.

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 (minimum franchise tax base) 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 2019.

Examples:

- The Hearing Office upheld a proposed franchise and excise tax assessment against a corporation that sold licenses purchased from another company and failed to treat the gain as business earnings¹⁶ 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). Here, the Hearing Office agreed that the sale of the licenses did not occur in the normal course of business, but it found that the gain received from the sale of the licenses was used in various business operations. Accordingly, the gains from the sales qualified as business earnings under the functional test.
- The Hearing Office abated a proposed assessment against an out-of-state holding company that sold its interest in an out-of-state company that had nexus with Tennessee. The holding company had no physical presence in Tennessee, did not conduct business in Tennessee, and did not meet any tests establishing nexus for Tennessee franchise and excise tax purposes.
- Tennessee law provides taxpayers with a job tax credit that can offset their franchise and excise tax liabilities if the jobs they create meet certain requirements, such as being "newly created in this state" and a full-time position.¹⁷ The Hearing Office upheld the Department's denial of a refund from a taxpayer who claimed this credit by counting previously part-time jobs that were changed to full-time positions, because the jobs already existed.
- The Hearing Office adjusted a proposed franchise and excise tax assessment against a retail liquor store operator that excluded rent expenses on three properties from its franchise tax return that did not become stores. The minimum measure of the franchise tax includes net annual rents of property rented and used in Tennessee. The proposed assessment was adjusted to remove the tax related to those properties because the retail store operator did not use the properties to conduct its business.
- When a Taxpayer files a final franchise and excise tax return, it is required to compute its franchise tax base using the average monthly value of net worth or the minimum franchise tax base if the final return is not the result of a same-day liquidation. The Hearing Office upheld the Department's denial of a refund request filed by a consumer product

¹⁶ Tenn. Code Ann. § 67-6-2001(4) (Supp. 2018).

¹⁷ Tenn. Code Ann. § 67-4-2109(B)(1) (Supp. 2018).

manufacturer that did not liquidate but moved its inventory from a warehouse in Tennessee to an out-of-state warehouse. The manufacturer had included only its warehouse rent on its final return and the auditor properly added the Taxpayer's average monthly value of the manufacturer's inventories and work in progress.

Miscellaneous Other Taxes

In addition to the tax categories discussed above, the Hearing Office occasionally conducts conferences on where the tax type is one that is less frequently seen. Below are some examples of topics the office addressed in FY 2019.

Examples:

- If a business owing taxes transfers its assets to avoid its tax liability, the transferee is liable for those taxes.¹⁸ The Hearing Office abated a proposed transferee liability tax assessment against a restaurant that opened five months in the same location after another restaurant with an outstanding tax liability had abandoned the premises and left its fixtures there. The new restaurant purchased its own equipment and the restaurant with the tax liability had not transferred its assets to the second restaurant.
- Dyed fuel is sold free from state and federal tax but must be used strictly for non-taxable, off-road purposes; users who introduce dyed fuel into a vehicle licensed for use on public highways are subject to a fine.¹⁹ The Hearing Office abated a proposed dyed fuel penalty against a farmer who showed that his truck was no longer licensed for highway use and was solely used on the farm.
- The professional privilege tax is on the privilege of maintaining an active license with certain professional licensing boards²⁰ and is due on June 1 of each year. The Hearing Office upheld a proposed professional privilege tax against a broker based out-of-state who did not do business in Tennessee but nevertheless held a Tennessee license. 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.
- The International Fuel Tax Agreement (IFTA) is an agreement among continental U.S. states and Canadian provinces to simplify reporting and payment of motor fuel taxes by interstate motor carriers. Carriers must keep detailed trip and fuel records accounting for all movement by a vehicle. If adequate records are not kept, auditors may estimate a carrier's liability using a standard of four miles per gallon. The Hearing Office upheld a proposed IFTA tax assessment based on an auditor's estimate where the trucking company provided records of fuel purchases but did not keep trip records.

¹⁸ Tenn. Code Ann. § 67-1-1444 (2013).

¹⁹ Tenn. Code Ann. § 67-3-809(2013).

²⁰ Tenn. Code Ann. § 67-4-1701 *et seq.* (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>.