



Administrative Hearing Office

FY2024 Annual Report & Informal Conference Summaries

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 Hearing Office personnel to resolve disputes about tax assessments and tax refund claim denials. Hearing officers 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.

For Fiscal Year 2024, the Hearing Office received 287 requests for informal conferences, 75 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>.

Conference Decisions in Fiscal Year 2024: 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's 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's underlying tax liability, the Hearing Office hears challenges to proposed personal tax assessments.

Examples:

- The Department made a proposed personal liability assessment against an individual with respect to unremitted taxes. The hearing officer found that the taxpayer was a person required to collect, truthfully account for, and pay over taxes collected— consistent with Tenn. Code Ann. § 67-1-1443.
- The Hearing Office abated a personal liability assessment against an individual involved in a business with delinquent taxes. The individual asserted that they were only an employee, were involved only in the operational aspects of the retail business and were specifically forbidden from a role in the business's financial aspects by the owner. Though they were added to the business's TNTAP account, the individual asserted this was not done with their knowledge. Finding no evidence that the individual had taken any specific action to divert taxes owed to the state or contradicting their account of their relationship to the business, the hearing officer abated the assessment.
- The Hearing Office abated a personal liability assessment against an individual whose company had been sold before the Department assessed the company for unpaid sales tax. The sales agreement stated that the purchaser would pay the outstanding tax liability, and the individual filed suit against the purchaser when it failed to do so. The hearing officer concluded the individual had not willfully failed to account for the tax due, and the inclusion of the tax payment clause coupled with the suit against the purchaser did not demonstrate an intent to defeat or evade payment.
- The Hearing Office abated a personal liability assessment against the owners of two restaurants. The hearing officer noted that Tenn. Code Ann. § 67-1-1443 both (1) applies to taxes actually collected for remittance to the Department of Revenue, and (2) requires that the personal liability taxpayer be responsible for both (a) "collect[ing], truthfully account[ing]

¹ Tenn. Code Ann. § 67-1-1443 (2013).

for, and pay[ing] over” those taxes, and (b) willfully failing to do so or otherwise willfully attempting to evade the payment of such taxes. In this instance, the majority of the underlying tax assessment was not for taxes actually collected, and while at least one owner was responsible for collecting, truthfully accounting for, and paying over the balance of the underlying assessed taxes, there was no indication that failure to do so had been willful on either owner’s part.

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 adjusted a successor liability assessment resulting from estimated assessments against the previous business. That predecessor business did not file a final sales-and-use tax return, resulting—per Audit Division policy—In estimated assessments for months after the last filed return. While the hearing officer concluded that the taxpayer had purchased the predecessor business and was a successor within the meaning of Tenn. Code Ann. § 67-6-513, the best information available to the Department indicated that the predecessor business was not in operation during the months for which the estimated assessments were made and there was thus no basis to hold the taxpayer liable for those assessments.
- The Hearing Office abated a proposed successor assessment against a company that had obtained an option to purchase a business but never exercised that option and never purchased the business. Tennessee’s successor liability statute imposes liability for unpaid sales or business taxes on a purchaser that does not get the required tax clearance, but when no purchase occurs, no tax liability can attach.
- The Hearing Office upheld a proposed successor liability against the purchaser of a company with an unpaid sales tax liability. Although the seller assured the purchaser he would pay the outstanding taxes, the seller did not do so, and the purchaser did not obtain a tax clearance letter or an affidavit from the seller stating all tax liabilities had been paid. While the assessment was upheld, the hearing officer assured the purchaser that the Department would not stop pursuing collection efforts against the seller.

- The Hearing Office upheld a proposed successor liability assessment, including penalties incurred by the predecessor corporation, against the purchaser of a business that had not obtained either a tax clearance letter or an affidavit from the purchaser. The purchaser asked that its predecessor's penalties be waived, but the hearing officer declined to do so because the assessment being challenged was the successor assessment only, and not the underlying assessment. The hearing officer noted that the underlying assessment had become final and was no longer open to challenge through the Hearing Office process.

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:

- The Hearing Office upheld the Audit Division's decision to conduct a purchase markup audit of a retailer to estimate taxable sales but adjusted the methodology. While the taxpayer's point-of-sale records reconciled to its sales tax reporting and sales reported on its federal returns, independently sourced purchase data—in tandem with the taxpayer's federally reported expenses, assets, liabilities, and capital—suggested a business operating at an unsustainable loss. Without another source of income to explain the viability of the business—or a plausible alternative explanation from the taxpayer—the auditor reasonably determined the Department's purchase data to be the best information available and used it as the basis of the purchase markup. The hearing officer did, however, direct some adjustments to the technical execution of the markup analysis.
- The Hearing Office upheld a proposed sales tax assessment against a used car dealership where its records did not support amounts reported on its sales tax returns. The auditor used the dealership's bills of sale to determine its actual sales and the amount of sales tax it

² Tenn. Code Ann. §§ 67-6-523 and 67-1-113.

³ Tenn. Comp. R. & Regs. 1320-05-01-.80(2).

⁴ Tenn. Code Ann. § 67-1-113(b).

collected. The auditor disallowed sales reported as tax-exempt out-of-state sales because the dealership did not keep three-day removal affidavits showing the vehicles had been removed from Tennessee.

- The Hearing Office upheld a proposed assessment where the auditors calculated a motor vehicle repair shop's sales using its bank records (for years the bank statements were complete) and sales reported on its federal income tax returns (for years when bank statements were incomplete). The shop did not use a cash register to track its sales, and instead used sales receipt booklets, which were also incomplete. The auditors gave the shop credit for reported exempt sales where the shop had supporting exemption certificates but disallowed the rest. Given the shop's lack of records, the hearing officer agreed the auditors had used the best information available to determine the shop's sales.
- The Hearing Office adjusted an assessment against a used car business. The taxpayer provided auditors with a printed summary of information ostensibly produced by its point-of-sale software but did not give them access to the software or its backing data. Relying on Tenn. Code Ann. § 67-1-113, the auditors determined the best information available were the taxpayer's bank deposit records, treating all deposits as sales other than deposits identifiable as government loans. At conference, the taxpayer insisted its owner had used the business's sole bank account for personal deposits, including a large loan from a friend, subsidies to the business from the owner's spouse, and deposits from friends for various non-business purposes. The hearing officer agreed with the auditors that the printed sales records were not reliable and did not substitute for the requirement under Tenn. Code Ann. § 67-1-113 to maintain records of sales including auditable underlying data. Under these circumstances, relying on bank deposits as the best information was reasonable. The hearing officer allowed the taxpayer to submit proof that deposits were not sales but required independent and reliable verification of a non-sales source. The hearing officer did not require the audit be adjusted for claims of exempt sales because despite offering various indicia of customers with non-Tennessee contact information, Tenn. Comp. R. & Regs. 1320-05-01-.03(3) requires removal affidavits signed by the purchaser, and none were maintained by the taxpayer.

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.⁵ 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.

⁵ 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.

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.⁶ These kinds of occasional and isolated sales are generally subject to sales or use tax.

Examples:

- The Hearing Office upheld an assessment of consumer use tax on a taxpayer's import of property purchased from a vendor in a foreign country. The taxpayer explained that neither the vendor nor the out-of-state (but U.S.-based) distributor through which the taxpayer bought the item disclosed any tax consequences, but the hearing officer found that Tennessee use tax is due on all items imported for use in this state, and the responsibility for reporting and paying the tax falls on the importing consumer.
- The Hearing Office upheld an assessment of consumer use tax against a taxpayer who had ordered a vehicle from a dealership and, before delivery, found a buyer willing to pay a higher price for it. The taxpayer obtained the resale certificate from the Department and presented it to the dealership, purchasing the vehicle without paying sales tax. Though the taxpayer collected sales tax from the subsequent purchaser, the Department assessed use tax because the use of the resale certificate was improper. The hearing officer agreed because resale certificates may only be issued to duly registered dealers (see Sales and Use Tax Rule 68(1)), and the taxpayer was not registered as a dealer (and could not be, because they were not licensed to deal automobiles as required by Tenn. Code Ann. § 55-17-109).
- The Hearing Office adjusted a consumer use tax assessment. The taxpayers—who are domiciled in a state bordering Tennessee—acquired three watercraft as part of purchasing a house in Tennessee. They brought a fourth watercraft—purchased before moving to their current domicile jurisdiction—to Tennessee and registered it here. The hearing officer upheld the assessment on the first three watercraft based on their fair market value because no price was identified in the transaction separate from the single lump sum paid for the house and watercraft. But the hearing officer adjusted the assessment on the remaining watercraft. Although the taxpayers did not have documentation of the amount of sales tax paid in the original purchase jurisdiction, they showed a lower value for the boat based on its insured value and documented that “taxes and fees” were paid at purchase. The hearing officer thus adjusted the tax base to the insured value of the boat and gave credit for the minimum amount of taxes that would have been paid in the original jurisdiction at the time of purchase.
- The Hearing Office adjusted a proposed consumer use tax assessment based on transactions involving several automobiles and boats. The taxpayer reported some of these transactions as even trades with no tax consequence and later admitted that they were actually cash sales. The hearing officer adjusted the tax to reflect the best estimate of the value of the vehicles but in light of the inaccurate reporting, did not credit the taxpayer's uncorroborated claims about the cash prices paid. The hearing officer declined to adjust the tax on another vehicle because the affidavit presented during the conference process showed irregularities. But the

⁶ Tenn. Code Ann. § 67-6-102(8)(C).

assessment for one vehicle, for which the sales price was supported by an uncontroverted bill of sale, was abated.

- The Hearing Office upheld a consumer use tax assessment based on a report from United States Customs identifying goods imported by the taxpayer. Though the goods were not identified with particularity, the report did identify them as belonging within a general category. The taxpayer claimed they could not recall such purchases, which was complicated by the lack of specific description. But U.S. Customs identified the taxpayer as the consignee of the goods and without corroboration of the taxpayer's claim, the hearing officer upheld the assessment. But the hearing officer did suggest a variety of avenues of investigation for the taxpayer that might support a later refund claim, including contacting the importing shipping company, providing bank and credit card statements from the period, and contacting Customs directly.

Sales and Use 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 fiscal year 2024.

Examples:

- A manufacturer that used a caustic chemical when manufacturing its product installed a pressurized cabinet around its plant controls to prevent the controls from being damaged. The hearing officer agreed with the manufacturer that components of the pressurized cabinet were exempt industrial machinery because they were used primarily for and were necessary to the manufacturing process in that the process would not be possible without the controls they protected.
- The Hearing Office reversed the denial of a sales tax refund filed by a staff augmentation company that provided temporary employees to supplement a client's IT staff. Tennessee taxes sales of computer software but exempts software created by a "person" (defined to include a broad array of business entities and arrangements) or a person's agents for the person's own use. Whether an agency relationship exists turns on a number of factors, the primary one being the degree of control that the principal exercises over the agent's work. In this case, the Hearing Office concluded the temporary employees were agents of the client, which supervised the employees, gave them assignments, signed their time sheets, approved their leave, and provided the employees with the resources to perform the work.
- The Hearing Office upheld the denial of a sales tax refund claim from a company that sells hotel furniture and equipment. The company charged its customer sales tax, but instead of paying the tax, the customer presented a resale certificate for another entity that had not purchased the items. The Hearing Office agreed the Department cannot honor a resale certificate from one company for a purchase made by another company.
- The Hearing Office adjusted an assessment of use tax against a seller of construction materials when the materials were installed by an unrelated third party, because the seller—which did not hold a resale certificate and is not a contractor-dealer—had not acted as a contractor.

Only dealers that purchase materials on a resale certificate—without paying sales tax—and use those materials in the construction of real property themselves are liable for use tax on those materials. Instead, the taxpayer would have been required to collect sales tax on the sale of the materials or document that the sale was exempt. In this case, however, the Hearing Office agreed that no tax was due because the seller sold tangible personal property to a qualified religious or charitable institution and obtained a valid exemption certificate.

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 fiscal year 2024.

Examples:

- The Hearing Office adjusted a proposed business tax assessment that classified delivery charges as taxable gross receipts. Under Business Tax Rule 18, delivery charges are subject to the business tax only when title to goods transfers to the buyer at the shipping location. In this case, the parties did not contractually specify the location of transfer of title. In these circumstances, Tennessee's version of the Uniform Commercial Code specifies that the place of delivery is the seller's place of business. Because the taxpayer's location was outside Tennessee, the delivery charges were not taxable receipts.
- The Hearing Office upheld an assessment against a taxpayer that sold medical hardware and equipment, including monitors and cables, to medical facilities. The taxpayer pointed to the business tax's exemption for receipts from the sale of "any materials, substances or other items of any nature inserted or affixed to the human body by duly licensed physicians or dentists or otherwise dispensed by them in the treatment of patients." Tenn. Code Ann. § 67-4-702(a)(23). The taxpayer argued its equipment ultimately connected to or contained an item that is affixed or inserted into a patient. The hearing officer determined this reading of the exemption contravened the plain meaning of the statutory language and upheld the assessment.
- Business tax rates are based upon a taxpayer's dominant business activity. The Hearing Office upheld an assessment of business tax based on the auditor's determination that a bakery should have been classified as a seller of prepared foods regardless of where the food was consumed (Classification 2G) instead of a seller of foods for home preparation and consumption. The hearing officer reasoned that the baked goods were prepared prior to sale, so Classification 2G was applicable.
- The Hearing Office upheld an assessment against a taxpayer whose business included selling tangible personal property on consignment on behalf of clients. At issue were sales in which the taxpayer sold items on this basis without identifying, at the time of the sale, the identity of the property owner on whose behalf the taxpayer acted. Tenn. Comp. R. & Regs. 1320-05-01-.01 provides that agents selling tangible personal property on behalf undisclosed principals are deemed the owner of the property for purposes of the sales tax and are required to collect

and remit tax on those sales. The hearing officer concluded that this rule applied to the taxpayer's sales and that the lack of disclosure at the time of sale controlled—and could not be cured by later disclosure—because the purpose of the rule is to identify the sales tax obligations of the parties at the time of the transaction.

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. For tax years ending on or before December 31, 2023, 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 fiscal year 2024.

Examples:

- A taxpayer reported a long-term capital gain from the sale of its entire business as well as interest earned on the proceeds from the sale as non-business earnings, and the Audit Division reclassified these as business earnings and assessed excise tax on the resulting difference in reported earnings. Consistent with *Newell Window Furnishing, Inc. v. Johnson*, 311 S.W.3d, 441 (Tenn. Ct. App. 2008), the hearing officer determined that the gain from a liquidation qualified as taxable business earnings under the “functional test” portion of the business earnings definition. But the hearing officer adjusted the assessment to exclude from business earnings interest income earned on the proceeds from the sale because the acquisition, use, and management of those funds were not an integral part of the now-liquidated business.
- The value of real property that is under construction and not being used by a taxpayer is not included in the calculation of the property factor under Tennessee law. When a taxpayer submitted amended franchise and excise tax returns, the Audit Division recalculated the company's franchise tax base to include an out-of-state property the company owned. The Hearing Office reversed a proposed assessment including the property in the factor because the property was being developed during the audit period to construct a building that was not yet occupied.
- Under Tennessee common law, an individual may have an employer/employee relationship with a business if various factors are met, the most important one being the business's right to control the work performed. So-called “common law employees” may be included in a business's payroll factor despite being paid by a different entity. The Hearing Office adjusted an assessment where a taxpayer's payroll factor computation had been disallowed because its workers were paid by an affiliate. The hearing officer reasoned that the workers were the taxpayer's common law employees in that they worked exclusively for the taxpayer at its separate location and under the business's control.
- The Hearing Office upheld a franchise and excise tax assessment against a company that sold its interest in an LLC and reported the gain as nonbusiness earnings. Tennessee's definition

of “business earnings” includes two tests: the “transactional test,” which includes earnings arising from transactions in a taxpayer’s regular trade or business, and the “functional test,” which includes gains from the acquisition, use, management, or disposition of property that is an integral part of the taxpayer’s regular trade or business activities. Because the company’s business was holding interests in LLCs, the hearing officer concluded that the company had disposed of an integral asset of its business.

- The Hearing Office upheld denial of a refund based on the disallowance of a previously granted “personal residence” exemption. Tenn. Code Ann. § 67-4-2008(a)(6) exempts the holding of a personal residence by an LLC if at least two-thirds (66.67%) of the activity of the LLC consists of holding a personal residence and at least one of its members lives in that residence. But the Taxpayer owned two personal residences, one of which it rented and in which no member resided, and the hearing officer concluded this was more than one-third (33.33%) of the Taxpayer’s activity. The hearing officer also found that the obligated member entity exemption (or “OME”) established by Tenn. Code Ann. § 67-4-2008(d) did not apply. This exemption requires that the members of the LLC fully obligate themselves for the debt of the LLC, and that this be incorporated in its articles of organization. This was not done in this instance and could not be done retroactively.

Miscellaneous Other Taxes and Common Issues

In addition to the tax categories discussed above, the Hearing Office occasionally conducts conferences in which the tax type is one that is less frequently seen. In addition, some issues—such as the statutes of limitations for assessments and refund claims—cut across tax types. Below are some examples of topics the office addressed in fiscal year 2024.

Examples:

- The Hearing Office upheld an IFTA and IRP assessment against a sole proprietor operating a semi-trailer truck. IFTA (the International Fuel Tax Agreement) is an agreement among 48 U.S. states and 10 Canadian provinces to simplify the reporting and payment of motor fuel taxes by interstate motor carriers by reporting distance traveled within the member jurisdictions. IRP (the International Registration Plan) is a registration reciprocity agreement among the states, the District of Columbia, and the provinces of Canada providing for payment of licensing and registration fees based on distance traveled among the member jurisdictions. The taxpayer did not maintain mileage records and the auditor adjusted reported miles-per-gallon (consistent with the IFTA manual) and disallowed credits for fuel purchased. And consistent with the IRP, the auditor increased registration fees by 20%, the penalty mandated by the plan. Because the taxpayer did not maintain records, the hearing officer upheld these adjustments.
- The Hearing Office upheld an assessment of professional privilege tax. The tax is imposed on the active holders of certain professional licenses and is due and payable on June 1 of each year for every person holding such a license on that date. The taxpayer in this instance held such an active license on June 1 of the tax year at issue but explained that they had not used the license in some time or otherwise earned income from it. But the hearing officer held that

the tax is on the privilege of holding the license and not on its use or income generated from its use. The only way to avoid liability for the tax is to surrender the license or assume an inactive status before liability attaches on June 1.

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>.