STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-9034
(615) 741-2501

Justin P. Wilson
Comptroller

October 17, 2011

The Honorable Ron Ramsey
Lt. Governor and Speaker of the Senate
301 6th Ave. North
1 Legislative Plaza
Nashville, Tennessee 37243

The Honorable Randy McNally
Chairman, Senate Finance Committee
301 6th Ave. North
Suite 307, War Memorial Building
Nashville, Tennessee 37243

The Honorable Beth Harwell
Speaker of the House
301 6th Ave. North
Suite 19, Legislative Plaza
Nashville, Tennessee 37243

The Honorable Charles Sargent
Chairman, House Finance Committee
301 6th Ave. North
Suite 206, War Memorial Building
Nashville, Tennessee 37243

Dear Lt. Governor Ramsey, Speaker Harwell, and Chairmen McNally and Sargent:

At your request, we have reviewed tax variance usage at the Tennessee Department of Revenue. Because commissioner-imposed variances are generally favorable to the department and are subject to appellate review, the primary focus of our review was taxpayer-requested variances granted by the Department of Revenue under the commissioner's discretion. It is our recommendation, based on our review, that the legislature should examine the existing approval process for granting tax variances.

Currently, state law makes tax refunds and tax penalty waivers above $15,000 subject to review and approval by the Attorney General's Office. The Attorney General's Office informed us that it reviews all refunds of more than $50,000 and penalty waivers of more than $25,000. State law also requires review and approval by the Attorney General's Office and the Comptroller's Office for compromises of tax liability of any amount. A variance (the departure from the statutory apportionment formula), however, currently requires no review or approval beyond the Commissioner of the Department of Revenue. The commissioner's authority to initiate and approve actions that result in the revision of tax liabilities is detailed in Exhibit A.

Exhibit A

Statutory Authority to Initiate and Approve Actions that Result in the Revision of Tax Liabilities

			Approvals			
#	Action	Commissioner Authority	Attorney General	Comptroller	F & A Commissioner	Governor
1	Refunds	Yes [A]	Subject to review if > $15k [B]	No	No	No
2	Penalty Waivers	Yes [C]	Subject to review if > $15k [D]	No	No	No
3	Compromise	Yes [E]	Yes [E]	Yes [E]	No	No
4	Variance	Yes [F]	No	No	No	No

[A] *Tennessee Code Annotated,* §67-1-1802 (a)(1)(A).
[B] *Tennessee Code Annotated,* §67-1-1802 (a)(6)(C).
[C] *Tennessee Code Annotated,* §67-1-802, §67-1-803 (a)(1)(A), §67-1-803 (e)(3), and §67-1-803 (e)(4)(B).
[D] *Tennessee Code Annotated,* §67-1-803 (e)(4)(C).
[E] *Tennessee Code Annotated,* §67-1-102 (b)(8). But see *Tennessee Code Annotated* §20-13-103 (compromise and settlement of litigation).
[F] *Tennessee Code Annotated,* §67-4-2014 (Excise Tax) and §67-4-2112 (Franchise Tax).

BUSINESS TAXATION AND UDITPA

The Uniform Division of Income for Tax Purposes Act (UDITPA), a model law drafted in 1957 by the National Conference of Commissioners on Uniform State Laws, was designed for enactment in states which assess tax on a business entity on the basis of net income. The goals of UDITPA were to create a practical means of assuring that an entity is not taxed on more than its net income in a particular state and to provide for equitable taxation results across states. UDITPA is built on the principle that business income should be fairly apportioned among the states which have contacts with that income.

Tennessee's business tax statutes are based on UDITPA; therefore, business income is taxed using the apportionment method that is embodied in UDITPA. Under the apportionment method, a multistate taxpayer's business income is prorated among the states in which the taxpayer does business. Accordingly, each state is permitted to tax that portion of the taxpayer's income that is proportional to the amount of business done in that state.

The standard apportionment formula is defined in Tennessee law as a fraction in which the numerator is the sum of the property, payroll, and sales factors of each taxpayer and the denominator is four. Each factor is a fraction in which the numerator is the taxpayer's respective property, payroll, or sales values in Tennessee and the denominator is the taxpayer's entire respective property, payroll, or sales. This formula is defined in both excise tax and franchise tax statutes.[1]

Departure from the Standard Apportionment Formula

If the apportionment method outlined above does not accurately reflect a taxpayer's true business activities in a particular state, a variance, or departure, from the standard apportionment

[1] *Tennessee Code Annotated,* §67-4-2012, §67-4-2110 and §67-4-2111.

formula may be appropriate. Tax variances occur in two ways—through audit and through a petition from the taxpayer.

When the department discovers, during the course of the audit, that the taxpayer's actual taxes paid do not reflect the taxes that should have been paid, the commissioner can impose a variance upon the taxpayer. Commissioner imposition of a variance normally results in increased tax revenue for the state. Variances may decrease tax revenue through taxpayer-initiated variance requests. The taxpayer must petition the commissioner, usually through an attorney or accountant, for a tax variance if the taxpayer believes that the statutory apportionment method doesn't fairly reflect the business that the taxpayer does in Tennessee.

Commissioner-imposed variances and commissioner denials of variances via taxpayer petition are subject to appellate review. Therefore, as noted above, the primary focus of our review was taxpayer-requested variances granted by the Department of Revenue.

FRAMEWORK FOR TAXPAYER-REQUESTED VARIANCES

In Tennessee, the Commissioner of the Department of Revenue is the chief tax administrator. When the commissioner makes a tax assessment under the standard apportionment formula, it is presumed to be valid and correct.[2] As a result, a taxpayer must formally request a variance from the tax assessed by the department under the standard apportionment formula.

The foundational framework for variance use is detailed in Section 18 of UDITPA. It provides that the tax administrator should vary the apportionment formula in cases where the system of allocation under UDITPA does not fairly represent the extent of a taxpayer's business activity within the state.

The relevant Tennessee tax variance statutes, which evolved from Section 18 of UDITPA, provide that the taxpayer may petition, or the department may require the following:

- Separate accounting;
- The exclusion of any one (1) or more of the formula factors;
- The inclusion of one (1) or more additional apportionment formula factors that will fairly represent the taxpayer's business activity;
- The use of any other method to source receipts for purposes of the receipts factor of the apportionment formula numerator or numerators; or
- The employment of any other method to effectuate an equitable computation, allocation and apportionment of the taxpayer's net earnings or losses that fairly represents the extent of the business entity's activities in Tennessee.[3]

Correspondingly, the above statutory language serves as the basis for the Rules of the Department of Revenue. The rules require that a taxpayer's application requesting a variance be in writing to the Commissioner of the Department of Revenue "setting forth reasons why the statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in the state."[4]

---

[2] *Howard v. U.S., 566 S.W.2d 521 (Tenn., 1978)*
[3] *Tennessee Code Annotated,* §67-4-2014 and §67-4-2112.
[4] *Tenn. Comp. R. Regs.* 1320-6-1-.35(1)(c).

The Rules of the Department of Revenue further require that a taxpayer must show by "clear and cogent evidence that peculiar and unusual circumstances exist which would cause application of said statutory provisions to work a hardship or injustice."[5] Courts in Tennessee have ruled that when a taxpayer requests a variance the taxpayer must show by "clear and convincing evidence" that the Commissioner of Revenue's application of the apportionment formula has caused taxation on business income derived outside of the state.[6] Courts in Tennessee have defined the "clear and cogent" evidence standard as being essentially similar to the "clear and convincing" standard.[7]

The Rules of the Department of Revenue supplement the statutory standard regarding the departure from the standard apportionment formula so that the variance statutes "permit a departure from the allocation and apportionment provisions only in limited and specific cases." The Rules of the Department of Revenue also require that the variance statutes "be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions."[8]

Commissioner Discretion

There is no dispute under current Tennessee law that the application of a variance is within the commissioner's discretion. Courts have held that the commissioner must exercise reasonable discretion in determining whether facts and circumstances justify departure from the statutory apportionment formula.[9]

To our knowledge, Tennessee courts have not addressed whether there are boundaries to the commissioner's discretion in determining whether the granting of a variance is justified.

While opinions and rulings of courts in other states are not binding in Tennessee, the Tennessee Supreme Court has utilized rulings on UDITPA matters from other jurisdictions that have adopted UDITPA.[10] In their rulings regarding variance use, courts from other states have stated that the relief provision is intended to provide relief only in exceptional circumstances which produced apportionment that could violate the Commerce Clause of the United States Constitution. These courts have further stated that the relief provision should be "narrowly interpreted"[11] and that there is a strong presumption in favor of the normal apportionment formula and against the use of the relief provision.[12]

In fact, one court, in discussing the question of narrow or broad interpretation of the relief provision, stated that a broad interpretation would defeat the purposes of obtaining uniformity through the adoption of a Uniform Act. The court's reasoning was that if different methods were permitted, different states would, without question, choose different methods, thus arriving at the same "chaotic condition" that occurred before the adoption of a Uniform Act.[13]

---

[5] *Tenn. Comp. R. Regs.* 1320-6-1-.35(1)(c).
[6] *American Tel. & Tel. Co. v. Huddleston*, 880 S.W.2d 682 (Tenn. App., 1994).
[7] *Pierce v. Flynn*, 656 S.W.2d 42 (Tenn. App., 1983).
[8] *Tenn. Comp. R. Regs.* 1320-6-1-.35(1)(a)(4).
[9] *American Bemberg Corporation v. Carson*, 219 S.W.2d 169 (Tenn. 1949) and *Peterson Mfg. Co. v. State*, 779 S.W.2d 784 (Tenn. 1989).
[10] *Holiday Inns, Inc. v. Olsen*, 692 S.W.2d 850 (Tenn., 1985).
[11] *Donald M. Drake Co. v. Department of Revenue*, 500 P 2d. 1041 (Or., 1972).
[12] *Roger Dean Enter. v. State*, 387 So.2d 358 (Fla.1980).
[13] *Deseret Pharmaceutical Co., Inc. v. State Tax Commission*, 579 P.2d 1322 (Utah, 1978).

VARIANCE TREATMENT UNDER PRIOR LAW

Tennessee adopted the relief provision (variance provision) of UDITPA in 1976. In doing so, prior law was repealed and the substantial language of UDITPA was adopted. Prior to the 1976 law change, the departure from the standard apportionment was most often referred to as the use of the "hardship provision" or the "relief provision." Our research has found that prior to the 1976 taxation law change, the Attorney General's Office was the statutorily prescribed approver of any use of the "hardship provision."

The relevant section of prior law is as follows:

> *If, because of peculiar or unusual circumstances inherent in a particular case, the application of the above formula would work a hardship or injustice, the commissioner, upon application of the taxpayer and upon such showing, is authorized, with the approval of the attorney-general, to adopt such other method of apportionment as would be fair and just under the facts of the case.*[14]

Upon the adoption of the substantial language of UDITPA, the taxation law changes removed the requirement for the Attorney General's Office to approve the commissioner's use of the hardship provision. The use of the provision from 1976 forward was left solely to the discretion of the commissioner. Based on our research, it appears the law change was identical to the provisions of UDITPA, which did not provide for any review outside of the commissioner.

OUR OBSERVATIONS OF VARIANCE USE

For the purposes of our review, we requested all variances awarded, denied, commissioner-imposed, or pending since 2000. As of the date of this letter, there were five commissioners during this time-period: Ruth Johnson (1995-2002), Loren Chumley (2002-2007), Reagan Farr (2007-2010), Charles Trost (2010), and Richard Roberts (2011). We requested all documentation related to taxpayer-requested variances to determine the circumstances behind an increased number of granted taxpayer-requested variances. Although Department of Revenue staff were fully cooperative in responding to our requests for information, we cannot be certain that all variances were disclosed to us because the department lacked a formalized or centralized system of maintaining the records related to variances.

Variances Granted, Denied, and Imposed

Based on available information, a listing by year of total variances granted, denied, and imposed by the commissioner is detailed in Exhibit B.

---

[14] *Tennessee Code Annotated,* §67-2917 (1975).

Exhibit B

Variances Granted, Denied, and Imposed (based on obtained information)						
Year	Approved Taxpayer-Requested Variances	Denied Taxpayer-Requested Variances	Pending	Total Requested Variances	Commissioner Imposed Variances	Total
2011	1	1	3 *	4	0	4
2010	5	4	1	10	6	16
2009	3	6	-	9	6	15
2008	6	1	-	7	2	9
2007	6	1	-	7	0	7
2006	4	0	-	4	1	5
2005	5	1	-	6	1	7
2004	1	0	-	1	0	1
2003	3	1	-	4	1	5
2002	0	0	-	0	1	1
2001	3	0	-	3	0	3
2000	3	2	-	5	1	6
Totals	40	17		60	19	79

* 1 variance pending from 2010 was approved in 2011.

As shown above, generally, approvals of taxpayer-requested variances occurred more frequently beginning in 2005 during the tenures of Commissioner Chumley and Commissioner Farr. During this time there were more taxpayer requests for variances. We noted that during Mr. Farr's tenure as commissioner, there was also an increase in commissioner-imposed variances.

As previously stated, the primary focus of our review was taxpayer requested variances granted by the Commissioners of the Department of Revenue.

Throughout the interviews we conducted as part of our review, several concerns related to variance issuance became apparent. When we discussed variances issued during our review period, department officials made it clear to us in our conversations that there were not regularly followed procedures regarding variances. In fact, one official described the variance process as an "ad hoc" procedure. Those department officials also expressed concerns to us about the appropriateness and reasoning for some of the variances that were granted.

Department officials acknowledged to us the increase in variances granted. We were advised that, generally, prior to our review period, the issuance of a variance was a very rare occurrence.

We spoke about the increased approvals of taxpayer-requested variances with former commissioner Farr. He told us that this was an anticipated result of his approach to tax administration. According to Mr. Farr, he saw a potential for abuse with certain tax issues, and he took the approach of requiring taxpayer disclosure on the face of tax returns to determine if certain expenses were legitimate arms-length transactions. He stated to us that as taxpayers realized that they must disclose information on these transactions on the face of the return, they became more proactive rather than waiting for issues to arise through the audit process. Mr. Farr also told us that

he expected that variance requests would continue to increase because of taxpayers being more proactive in analyzing their tax situation in Tennessee.

While there could be valid reasons for an increase in approvals of taxpayer requested variances, we believe caution, scrutiny, and consistency must be exercised in the issuance of variances due to the potential for abuse.

Policies, Procedures, and Documentation

In obtaining information for our review, we learned that there were no department rules, procedures, or policies regarding taxpayer-requested variances other than the previously mentioned *Tennessee Code Annotated* sections and Rules of the Department. We also learned that there is no formalized or centralized recordkeeping mechanism or location for maintaining files of variances, regardless of whether they were awarded, denied, commissioner-imposed, or pending. We had to obtain documentation from various locations and parties within the Department of Revenue. In fact, in collecting the documentation for our review it became clear that the commissioner's office was the only section in the department that had actual knowledge of all variances. The department's audit division had the most complete documentation regarding variances. The audit division had created a listing of variance information since it is essential to their work. While their listing was certainly helpful, it was not entirely complete. This situation served to effectively eliminate transparency and appropriate coordination of the variance process.

Based on our review of the taxpayer-requested variance files, we noted that there were situations in which there was not enough information for a third party to fully understand the basis for the grant or denial of a taxpayer-requested variance.

Due to the manner in which the taxpayer-requested variances were granted or denied, there was no effective way to evaluate independently the appropriateness of the taxpayer-requested variances we examined.

Decision-Making Process

In addition to the lack of a recordkeeping mechanism or centralized location for variance files, we discovered that no formalized analyses were documented regarding taxpayer-requested variances. Further, there was no evidence of investigation of the effect on similarly-situated taxpayers or of the precedent that may be set by granting a particular variance.

We asked former commissioners Johnson, Chumley, and Farr about their contemplation of taxpayer-requested variances and what sort of analysis was completed. They told us that there was contemplation and investigation but acknowledged that nothing was formalized.

We discovered that key department employees who should be involved the decision-making process to grant taxpayer-requested variances, such as the department's General Counsel, audit staff, and other relevant department officials, were at times excluded from the process, and, in some instances, were not even aware of the taxpayer-requested variances that a commissioner granted or promised.

Review of a taxpayer-requested variance requires an analysis of the law in Tennessee and the specific fact situation of the taxpayer making the request. During our review, we learned that inconsistent application of tax laws can be problematic when the decisions of the department and of the commissioner must be defended legally. Inconsistent application of the tax laws could give the appearance of selective tax enforcement and preferential treatment, as well as unequal treatment of similarly-situated taxpayers.

One experienced department official gave us an example of a situation in which a taxpayer-requested variance was granted to one taxpayer but was denied to a similarly-situated taxpayer. The department official, while acknowledging the commissioner's discretionary authority, expressed discomfort to us about that particular taxpayer-requested variance award.

In addition to issues of inconsistent application of tax law, problems could arise with ongoing litigation involving the state and the taxpayer, or a similarly situated taxpayer, when a taxpayer-requested variance is issued without internal review and without any consultation or knowledge of the Attorney General's Office. Such approvals could undermine existing cases being handled by the Attorney General's Office on behalf of the department. Furthermore, input from the Attorney General's Office may be appropriate in recognizing areas where legal precedent exists, or areas where a legal precedent should be set.

These issues require careful scrutiny because the granting of a variance not truly related to unfair apportionment could raise issues under the Commerce Clause of the U.S. Constitution.[15]

Economic Development

Problematic situations could occur when variances are awarded for economic development purposes, rather than strictly for tax apportionment reasons. We have found that there is national discussion about the pitfalls of variances being used for economic development purposes.

While we were unable to ascertain the motivation and reasoning for granting the taxpayer-requested variances from the documentation provided, we noted references to economic development in the form of job creation and current or potential employment information.

We reviewed 59 variances—40 requested by the taxpayer and 19 imposed by the commissioner—beginning in 2000. Of the 40 taxpayer-requested variances, we identified at least 7 instances since 2002 in which the variance award letters contained language that suggested economic development, such as job creation or retention, was at least part of the discussion in relation to the taxpayer's variance request and award. Specifically, taxpayers would use job creation and economic impact as part of their argument for why they should be awarded a variance. We also noted variance requests from taxpayers that used tax treatment in Tennessee versus tax treatment in other states seemingly as a negotiation tool, stating that Tennessee's tax treatment was a "penalty" and a "disincentive" for doing business in Tennessee.

We noted a specific example where a variance was granted in order to allow the transfer of job tax credits in a merger situation in 2006. This appears to be contrary to Tennessee Code Annotated §67-4-2109(e) which prohibits the transfer of such tax credits. A tax credit carryforward

[15] *Complete Auto Transit, Inc v. Brady*, 430 U.S. 274 (1977).

can only be taken by the taxpayer that generates it, unless the transferee is merged out of existence and the surviving transferor has no income, assets, liabilities, equity or net worth. In this instance, the merged company was allowed to utilize the value of the job tax credits through the variance granted by the department, although the acquiring company did not qualify for the exception.

In some situations, it appeared that a variance was promised to a taxpayer as part of an economic investment in Tennessee. The variance itself was promised before the actual economic investment. Based on our review, we found that a variance was issued at least three times based on agreements entered into between the taxpayer and the Department of Economic and Community Development. In two separate situations, variances appear to have been promised through such agreements. One of the two promised variances has been requested but not yet issued, and the other potential variance has not yet been formally requested by the taxpayer.

In addition to instances in which taxpayer-requested variance award letter language was negotiated with the taxpayer, we also observed correspondence between Commissioner Farr and certain department employees instructing the taxpayer to make changes to the taxpayer's variance request letter. In those instances, the language in the letter was expounded upon and economic development language was minimized to emphasize a reason more in line with the statutory basis for the award of a taxpayer-requested variance. By statute, the burden is on the taxpayer to show why the variance from the statutory apportionment formula is needed. The changes in the letters give the impression that the department helped the taxpayer meet the requirement of showing why the variance was needed.

We discussed the economic development issues with former commissioners Johnson, Chumley, and Farr. All were adamant that all variance decisions were based solely on arriving at the proper taxation of a taxpayer's business activity in Tennessee. The former commissioners told us that, under their administrations, a Department of Revenue employee either worked closely with, or was physically located at, the Department of Economic and Community Development. This was to make sure that the proper Tennessee tax information was being presented to companies considering locating in Tennessee.

In cases in which a variance was promised to a taxpayer as part of the economic development deal, Mr. Farr told us that this occurred in order to let the taxpayer know what to expect on the front end before the investment in Tennessee. Mr. Farr told us that many times the variance was remedying a unique, taxpayer-centric situation in which the taxpayer's true business in Tennessee would not be properly reflected without the variance. Ms. Chumley told us that it is part of the department's responsibility to assist taxpayers in identifying the means available to ensure fair taxation.

Whether the variance was promised as an incentive or whether it was merely assisting a taxpayer in identifying a necessary and appropriate tax variance is difficult to ascertain without the taxpayer going through the traditional written request process identifying the circumstances supporting the requested variance. Documentation of the procedures used for granting taxpayer-requested variances is especially important in variance decisions because the negative tax effect of granting a taxpayer's requested variance could involve millions of dollars in state tax revenues.

Monitoring for Changes in Circumstances

The variance statutes and the Rules of the Department of Revenue provide that variances continue until revoked as long as the facts and circumstances leading to the issuance of the variance remain substantially unchanged. When we asked department officials about ongoing monitoring for changes in circumstances, they indicated that the monitoring responsibility was a function of the Audit Division. Based on the information we obtained, there does not appear to be a formalized process or procedure for the ongoing monitoring of variances to determine if they should be revoked or amended. We only observed one occurrence where a variance was revoked and that variance was revoked prospectively from the date of revocation letter. Other than that instance, we did not observe any revocations since 2000, or any documentation of an ongoing review of variances issued to determine whether those variances continued to be appropriate.

We do not believe the department should rely on taxpayers that have been awarded variances to self-report circumstances which could negate the basis for their variance award. Furthermore, the Audit Division does not audit every taxpayer every year. Reliance cannot be placed on the Audit Division to question or reevaluate the commissioner's decisions without a directive to do so.

Department Changes Regarding the Variance Process

The department has recently created a formalized process to thoroughly evaluate each taxpayer variance request. The document flow used for variance requests is designed to follow a path similar to that taken by a claim for refund. The new policy and procedure is in effect as of August 17, 2011.

The goal of the new process is to provide for a system in which multiple levels of department employees look at the variances in order to fully evaluate the impact of granting or denying the request. Under this process, members of the Audit Division, including auditors and the division director, will make an initial recommendation. The legal office will review audit's recommendation, add its own recommendation, and forward both to the Commissioner's Office for review and a final determination. Finally, the variance documentation will be scanned into the department's electronic database. According to the department, this new procedure will provide increased checks and balances and improve the transparency of the process.

Conclusion

Without knowledge of all the facts and circumstances considered, it is difficult to understand the reasoning behind the variances issued. Tax law is complicated and can be subject to interpretation, and there could be defensible positions on both sides of the request for each variance granted or denied. Unchecked power, however, could lead to abuse when these decisions, which involve potentially millions of tax dollars, are made with little or no documentation or review. Given the information presented in this letter, some checks on the unfettered variance discretion of the commissioner may be appropriate.

We recommend that

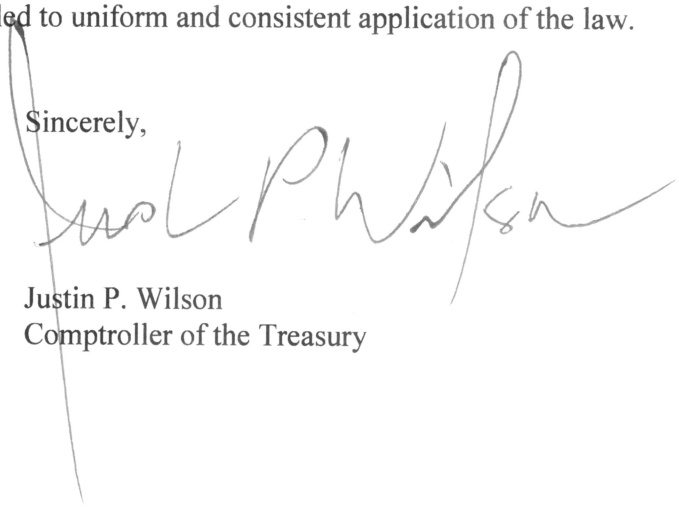
- the Legislature should consider enacting legislation requiring additional approvals to the variance process or review of variances granted or denied with the specific goal of achieving uniformity, fairness, and transparency;

- the Department of Revenue should continue with its newly implemented formalized tracking system for variances so that all variance considerations are known and communicated to the appropriate individuals in the Department of Revenue and complete documentation is maintained for all variance requests, approvals and denials; and

- the Department of Revenue should develop and install a formal and ongoing review process of awarded variances to determine current applicability and fairness.

The taxpayers of Tennessee are entitled to uniform and consistent application of the law.

Sincerely,



Justin P. Wilson
Comptroller of the Treasury

JPW/tsg

cc: Richard H. Roberts, Commissioner, Department of Revenue
Robert E. Cooper, Jr., Attorney General
Herbert Slatery, Counsel to the Governor