

Safe Harbor Established for Trusts and Estates

Franchise,
Excise
taxes
notice

"The Tax Revision and Reform Act of 1999," Chapter 406 of the Public Acts of 1999, repeals Tennessee's franchise and excise tax statutes (Title 67, Chapter 4, Parts 8 and 9) and enacts new franchise and excise tax statutes, which will be codified as Title 67, Chapter 4, Parts 20 and 21. For most taxpayers, the new franchise and excise tax statutes will be effective for tax years beginning on or after July 1, 1999.

The new act expands the types of business subject to Tennessee franchise, excise taxes to include, among other entities, certain trusts that were not previously subjected to such taxes. Questions have arisen as to the types of trusts that the Department of Revenue will consider subject to taxation under the new law, and the business community has requested guidance in this regard.

The purpose of this notice is to set out for certain trusts and estates a safe harbor from taxation. If a trust or estate falls within the safe harbor, the department will not consider it subject to franchise and excise taxes under the new law. Estates and trusts not within the safe harbor may or may not be subject to taxation depending on the specific facts and circumstances.

For purposes of the Tennessee franchise, excise tax, Tenn. Code Ann. Section 67-

4-2004(16) defines a "person" or "taxpayer" as follows:

"Person" or "taxpayer" means every corporation, subchapter S corporation, limited liability company, professional limited liability company, registered limited partnership, professional registered limited liability partnership, limited partnership, cooperative, joint-stock association, business trust, regulated investment company, real estate investment trust, state-chartered or national bank, state- or federally-chartered savings and loan association, and any other organization or entity engaged in business: but does not include sole proprietorships or general partnerships; and provided that all such entities set forth herein shall be classified as such in accordance with the provisions of 26 U.S.C. Section 7701 and the federal regulations and rulings promulgated thereunder. (Emphasis Added)

Tenn. Code Ann. Section 67-4-2007(a) imposes the excise tax on "All persons, except those having not-for-profit status . . ." and subsection (b) provides that the excise tax shall apply to "taxpayers doing business within this State. . .". Subsection (c) states that the excise tax ". . . shall apply to taxpayers whose business is being conducted by a receivership or trusteeship . . ." Tenn. Code Ann. Section 67-4-2105 contains

similar provisions with regard to the franchise tax.

Accordingly, any "business trust" (regardless of whether it has issued certificates to its beneficiaries or participants) or "real estate investment trust" doing business in Tennessee will be subject to Tennessee franchise, excise taxes.

Trusts other than "business trust[s]" and "real estate investment trust[s]" may well fall within the classification of ". . . any other organization or entity engaged in business . . ." and thus be subject to Tennessee franchise, excise taxes if actually ". . . engaged in business . . .".

T.C.A. § 67-4-2006(a) sets forth the definition of the terms "net earnings" and "net loss" for excise tax purposes, but provides no definition for a decedent's estate. Because of this provision and because a decedent's estate is never formed with the intention of engaging in business, a decedent's estate will not be considered to be subject to either franchise or excise taxes as long as the administration of the estate is not unduly prolonged. The Tennessee Department of Revenue will use the same standards as set forth in U.S. Treas. Reg. § 1.641(b)-3(a) to determine whether the administration of a decedent's estate is unduly prolonged. The Department of Revenue will not assert that the administration of an estate should be terminated prior to two years after the death of the decedent.

In addition to the foregoing exception for a decedent's estate, the Tennessee Department of Revenue will not consider a qualified funeral trust, as described in I.R.C. § 685, to be

"engaged in business" within the meaning of Tenn. Code Ann. Section 67-4-2004(16) so as to be subject to Tennessee franchise, excise taxes. Other trusts, not including a business trust (as defined in U.S. Treas. Reg. & 301.7701-4(b)) or real estate investment trust, will not be considered "engaged in business" within the meaning of Tenn. Code Ann. Section 67-4-2004(16) if such trusts are described in either I.R.C. §§ 401(a), 403(b) or 408, or are exempt under I.R.C. § 501(a) and described in I.R.C. § 501(c)(3), (11) (17), (18), (22), (24) or (25); or if they meet all of the following criteria:

- (1) The entity is legally formed as a trust and is classified as an ordinary trust under U.S. Treas. Reg. § 301.7701-4(a) or is either a revocable trust or a trust described in I.R.C. § 4947.
- (2) All of the trust beneficiaries are individuals, not-for-profit entities as the term "not-for-profit" is defined in Tenn. Code Ann. Section 67-4-2004(15), estates or other trusts that are within the safe harbors established by this notice, or general partnerships in which all the partners are estates or trusts within the safe harbor established in this notice.
- (3) The trust is not a business trust or real estate investment trust, or other entity otherwise subject to franchise, excise taxes under applicable statutes.
- (4) All of the trust's investments and assets (except for a de minimis amount that exceeds neither 5% of the trust's gross income nor

5% of the book value of the trust's assets determined in accordance with generally accepted accounting principles) consist of holding, collecting income from or buying, selling or exchanging one or more of the following:

(a) Investments that generate portfolio income as defined under U.S. Treas. Reg. § 1.469-2T(c)(3) or income from sources of the type set forth in I.R.C. § 851(b)(2) with respect to regulated investment companies.

(b) Policies of insurance on the lives of one or more individuals or on the property owned by the trust.

(c) Farmland or one or more personal residences if such activity would be exempt if engaged in by the trust through a limited partnership, limited liability company or limited liability partnership under Tenn. Code Ann. Section 67-4-2008(6).

(d) Assets received from an individual or an entity not subject to Tennessee franchise, excise taxes under applicable law if both of the following conditions are met:

(i) Such assets are received (A) as a gift, bequest or devise, (B) as a contribution by an individual or his or her spouse to a revocable trust, (C) through purchase, including a

purchase in consideration of an installment note, if each beneficiary of the trust bears to the seller one of the relationships specified under Tenn. Code Ann. Section 67-8-102(1) for Class A donees or is a niece or nephew of the seller, or (D) in substitution for assets originally received in one of the foregoing manners; and

(ii) Such assets are one or more of the following:

(A) Leased tangible property used in a rental activity as defined under I.R.C. § 469(j)(8) and applicable regulations thereunder but including property leased to an entity in which the lessor owns an interest.

(B) Stock in a subchapter S corporation or an interest in a limited liability company, registered limited liability partnership, or limited partnership (regardless of whether the K-1 schedule from that entity characterizes all or part of the income allocable from that entity as income from a trade or business), as long as the Trustee neither: (i) in its nonfiduciary capacity serves as an officer, director, general partner,

governor or manager of such entity, nor (ii) "materially participates" in the entity as determined in accordance with the rules under I.R.C. § 469(h) and U.S. Treas. Regs. §§ 1.469-5 and 1.469-5T (without regard to U.S. Treas. Reg. § 1.469-5T(e)). For example, a Trustee who is a limited partner and who materially participates but for the exception in U.S. Treas. Reg. § 1.469-5T(e) shall be treated as materially participating. A Trustee shall not be deemed to be an officer, director, general partner, governor or manager due to its ability to appoint itself to serve in any such capacity.

(C) Timberland or mineral interests in land if there is no active exploitation of such timber or minerals by the entity other than the sale or lease of standing timber or minerals to an unrelated party.

(D) Patents and copyrights provided that the protected invention or work was created by another and that the patent or copyright was later transferred to the trust as above provided and is licensed or held to

be licensed by the trust for royalty income.

Have questions or comments? Please let us know. [Contact us.](#)

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