TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING #00-23

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Definition of "financial institution", entities included in combined franchise, excise tax return for unitary group of financial institutions, and taxation of income from real estate investment trust.

SCOPE

Revenue rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue rulings are advisory in nature and are not binding on the Department.

FACTS

Corporation A is a bank holding company, registered under the Federal Bank Holding Company Act of 1956. Corporation A is incorporated under the laws of Tennessee and is commercially domiciled in Tennessee. Corporation A holds 100% of the stock of a banking corporation, Corporation B, which is also incorporated and commercially domiciled in Tennessee. Corporation A's principal source of income is from dividends received from Corporation B.

Corporation B does business in Tennessee and in various other states, accepting deposits which are insured by the Federal Deposit Insurance Corporation (FDIC). Corporation B's principal source of income is from interest received from the conduct of its banking operations. Corporation B also owns 100% of the stock of Corporation S1, which is incorporated and commercially domiciled in Tennessee.

Corporation S1 is a sub-tier holding company and conducts no banking activities. Its only asset is the ownership of the stock of Corporation S2. Its income therefore consists solely of dividends which it receives from its S2.

Corporation S2 is incorporated and commercially domiciled in Tennessee. S2 is also a sub-tier holding company, and its principal source of income (greater than 50%) is from dividends which it receives from a real estate investment trust (REIT).

The REIT is incorporated in and commercially domiciled in Tennessee. The REIT may invest in real estate, in real estate mortgage loans, and in participation interests in real estate mortgages. At present, the REIT's investments consist solely of participation interests in real estate mortgages.[1]

QUESTIONS

1. Which of the entities are considered to be "financial institutions" as defined in T.C.A. §67-4-2004(8)[2]?

2. What are the filing requirements of the entities for Tennessee franchise, excise tax purposes?

3. Assuming that the REIT is in the unitary group, what are the REIT's "net earnings" for purposes of the Tennessee excise tax?

RULINGS

1. Corporation A, Corporation B, Corporation S1, and the REIT[3] are financial institutions for Tennessee franchise, excise tax purposes. Corporation S2 is not a financial institution for Tennessee franchise, excise tax purposes.

2. Assuming that a unitary relationship exists between them, Corporation A, Corporation B, Corporation S1, and the REIT[4] are required to file a Tennessee franchise, excise tax return on a combined basis. Corporation S2 will be required to file its own separate Tennessee franchise, excise tax return.[5] Net earnings for the combined unitary group of financial institutions will be combined federal net earnings before the net operating loss deductions and special deductions subject to the adjustments set forth in T.C.A. § 67-4-2006(b)(c) and (d).

3. Assuming the REIT is a part of the unitary group, the combined net earnings of the unitary group include the REIT's "real estate investment trust income" as defined by 26 U.S.C. §857(b)(2).

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[1] The initial ruling request stated that the REIT may invest in real estate, in real estate mortgage loans, and in participation interests in real estate mortgage loans. Additional information was provided that at present, all investment was in participation interests in real estate mortgages. A "participation interest in a real estate mortgage" is described by the party requesting the ruling as a loan shared with other financial institutions.

[2] Prior to the enactment of Public Chapter 406 of the Public Acts of 1999 this statute was codified at T.C.A. § 67-4-804(a)(8).

[3] See Footnote 8.

[4] See Footnote 8.

[5] The ruling request does not ask whether the activities of Corporation S2 in Tennessee give rise to more than the minimum franchise tax liability, nor does it give sufficient information to make that determination.

ANALYSIS

1. Which Entities Are Financial Institutions

For purposes of the franchise, excise tax, T.C.A. §67-4-2004(8)[6] defines a financial institution as follows:

> "Financial institution" means a holding company, any regulated financial corporation, a subsidiary of a holding company or a regulated financial corporation, or any other person that is carrying on the business of a financial institution. However, "financial institution" does not include insurance companies subject to tax under §§ 56-4-201 - 56-4-214.

T.C.A. §67-4-2004(10) defines a "holding company" as:

> [a]ny corporation defined as a "bank holding company" under 12 U.S.C. § 1841(a) of the Bank Holding Company Act of 1956, as it may be amended from time to time; or any corporation defined as a "savings and loan holding company," "multiple savings and loan holding company," or "diversified savings and loan holding company," under 12 U.S.C. § 1467 (a)(1), as it may be amended from time to time.

T.C.A. §67-4-2004(17) defines "regulated financial corporation" as

> [A]n institution, the deposits, shares, or accounts of which are insured under the Federal Deposit Insurance Act, by the federal savings and loan insurance corporation, or any institution which is a member of a federal home loan bank, any other bank or thrift institution incorporated or organized under the laws of any taxing jurisdiction, or any foreign country which is engaged in the business of receiving deposits, any corporation organized under the provisions of 12 U.S.C. §§ 611-631 (Edge Act corporations), and any agency of a foreign depository as defined in 12 U.S.C. § 3101.

T.C.A. §67-4-2004(2)(A) defines the "business of a financial institution" as follows:

> (2) (A) "Business of a financial institution" means:
> (i) The business that a regulated financial corporation may be authorized to do under state or federal law or the business that its subsidiary is authorized to do by the proper regulatory authorities;
> (ii) The business that any person organized under the authority of the United States or organized under the laws of any other taxing jurisdiction or country does or has authority to do which is substantially

[6] Prior to the enactment of Chapter 406 of the Public Acts of 1999 the only entities that could be classified as financial institutions were holding companies, regulated financial corporations, subsidiaries of holding companies, or any other corporation organized under the laws of the United States or any other taxing jurisdiction that carried on the business of a financial institution under the former T.C.A § 67-4-804(a)(8).

similar to the business that a corporation may be created to do under title 45, or any business that a corporation or its subsidiary is authorized to do by title 45;

(iii) Otherwise making, acquiring, selling or servicing loans or extensions of credit including, but not limited to, the following:

(*a*) Secured or unsecured consumer loans;

(*b*) Installment loans;

(*c*) Mortgage or deeds of trust or other secured loans on real or tangible personal property;

(*d*) Credit card loans;

(*e*) Secured or unsecured commercial loans of any type;

(*f*) Letters of credit and acceptance of drafts;

(*g*) Loans arising in factoring; and

(*h*) Any other transactions of a comparable economic effect;

(iv) Leasing or acting as an agent, broker or adviser in connection with leasing real and personal property that is the economic equivalent of an extension of credit; or

(v) Operating a credit card business.

(B) Notwithstanding the provisions of this subdivision (2), if the business of a financial institution generates less than fifty percent (50%) of a corporation's gross income, the corporation shall not be considered to be a financial institution under subdivision (8). For purposes of this subdivision (2)(B), the computation of gross income of a corporation does not include income from nonrecurring, extraordinary transactions.

Therefore, for Tennessee franchise, excise tax purposes, T.C.A. §67-4-2004(8) treats a corporation as a financial institution if it is not an insurance company subject to tax under T.C.A. §§56-4-201 - 56-4-214 and meets any one of the following criteria:

- It is a holding company as defined by T.C.A. §67-4-2004(10).
- It is a regulated financial corporation as defined by T.C.A. §67-4-2004(17).
- It is a subsidiary of a holding company, as that term is defined by T.C.A. §67-4-2004(10).
- It is a subsidiary of a regulated financial corporation, as that term is defined by T.C.A. §67-4-2004(17).
- It is carrying on the business of a financial institution as defined by T.C.A. §67-4-2004(2)(A).

When the above criteria are applied to the facts presented, the following conclusions are reached.

Corporation A is registered as a bank holding company under the Federal Bank Holding Company Act of 1956, meeting the definition of a “holding company,” and therefore is a financial institution for franchise, excise tax purposes.

Corporation B accepts deposits which are insured by the FDIC, meeting the definition of “regulated financial corporation” and therefore is a financial institution for franchise, excise tax purposes.

Corporation S1 is a subsidiary of Corporation B which is a "regulated financial corporation." Therefore Corporation S1 is a financial institution for franchise, excise tax purposes.

Corporation S2 is not a bank holding company. It is not a regulated financial corporation. It is a subsidiary of Corporation S1, which is neither a holding company nor a regulated financial corporation. Corporation S2's principal source of income (greater that 50%) is generated from the receipt of dividends from the REIT, not from those activities which constitute the "business of a financial institution". Therefore, Corporation S2 is not a financial institution for franchise, excise tax purposes.

The **REIT** derives its income from participation interests in real estate mortgage loans.[7] This receipt of this income places the REIT's activities within the definition of "carrying on the business of a financial institution" as contemplated under T.C.A. § 67-4-2004(2)(A)(iii)(c) [8]. Therefore, the REIT is a financial institution for franchise, excise tax purposes.

2. Reporting Requirements

T.C.A. § 67-4-2006(a)(3) requires financial institutions that form a unitary business to file a combined return and pay tax on all operations of the unitary business. Similarly, T.C.A. § 67-4-2114(c) of Tennessee's franchise tax law provides that "financial institutions which form a 'unitary business' … shall file a combined return … ." T.C.A. § 67-4-2114(c).

T.C.A. § 67-4-2004(25) defines "unitary business" as follows:

> "Unitary business" means business activities or operations of financial institutions that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. "Unitary business" may be applied within a single legal entity or between multiple entities. "Unitary group" includes those entities that are engaged in a unitary business wholly within or within and without this state;
>
> (A) Unity is presumed whenever there is unity of ownership, operation and use evidenced by centralized management or executive force,

[7] See Footnote 1.

[8] Note that under T.C.A. § 67-4-2004(7)(C)(iii) "a financial institution is not considered to be conducting the business of a financial institution in [Tennessee] if the only activity of the financial institution in Tennessee is the ownership … of an interest in a loan, lease, note or other assets attributed to this state and in which the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner." The ruling request does not state whether or not the loans to which the REIT has its participation interests are attributed to Tennessee or whether the payment obligations were solicited and entered into by a person that is independent and not acting on behalf of the owner. In the event that the facts are such that this statute applies, the REIT would not be considered a financial institution, would not be included in the combined return filed by the unitary group, and would have to file its own separate entity basis franchise, excise tax return under franchise, excise tax laws applicable to business entities that are not financial institutions.

> centralized purchasing, advertising, accounting or other controlled interaction among entities that are engaged in the business of a financial institution. The absence of these centralized activities does not, however, necessarily evidence a nonunitary business;
>
> (B) Unity of ownership does not exist unless the corporation is a member of two (2) or more business entities and more than fifty percent (50%) of the voting stock of each member is directly or indirectly owned by:
>
> (i) A common owner or common owners, either corporate or noncorporate; or
>
> (ii) One (1) or more of the members of the group.

The ruling request asks that the department assume that the requisite unitary relationship exists between the corporations. Assuming that the unitary business requirements of T.C.A. § 67-4-2004(25) are met, since Corporation A, Corporation B, Corporation S1, and the REIT[9] are unitary financial institutions, they are required to file franchise, excise tax returns on a combined basis in the manner specified by the law.

Under the definition of a "unitary business" in T.C.A. § 67-4-2004(25), it can be seen that a business entity that is not a financial institution cannot be part of a unitary business as that term is defined for purposes of the franchise, excise tax. Since Corporation S2 is not a financial institution, Corporation S2 will not be permitted or required to be included in the combined franchise, excise tax return filed by the other entities. Since Corporation S2 is incorporated and domiciled in Tennessee it will, at a minimum, be required to file and pay, on a separate entity basis, Tennessee's minimum franchise tax of $100.00.[10] In the event Corporation S2 does business in Tennessee so as to be subject to more than the minimum franchise tax, it must file its franchise, excise tax return on a separate entity basis to include only its own operations.

3. Net Earnings of Real Estate Investment Trust[11]

T.C.A. § 67-4-2007(a) imposes the Tennessee excise tax on the "net earnings" of all persons, except those having not for profit status, doing business in Tennessee. "Net earnings" is defined by T.C.A. §67-4-2006. For a unitary business, T.C.A. § 67-4-2006(a)(3) defines "net earnings" as:

> [T]he combined net earnings as defined in subdivision (a)(1) for all members of the unitary group with all dividends, receipts and expenses resulting from transactions between members of the unitary group excluded, and subject to the adjustments in subsection (b) on a combined basis.

It has previously been determined that Corporation A, Corporation B, Corporation S1, and the REIT are financial institutions. The ruling request asks that the department

[9] See Footnote 8.
[10] T.C.A. § 67-4-2119.
[11] See Footnote 8.

assume that the REIT is part of the unitary group. Therefore, the net earnings of the REIT, as defined in T.C.A. §67-4-2006(a)(1) are to be included in the net earnings on the group's combined return.

T.C.A. §67-4-2006(a)(1) defines "net earnings" as:

> federal taxable income before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241-247 and 249-250, and subject to the adjustments in subsection (b) and (c) of this section.

The combined net earnings of the unitary group would include the REIT's "real estate investment trust taxable income" as defined under federal law and the combined federal net earnings of the unitary group would be subject to the adjustments set forth in T.C.A. § 67-4-2006(b)(c) and (d).

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