

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 01-01**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of the Tennessee franchise, excise tax exemption codified at Tenn. Code Ann. §§ 67-4-2008(10)(A) and 67-4-2105(a), to certain purportedly family owned non-corporate entities.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a revocation of the ruling must inure to the taxpayer's detriment.

FACTS

The [X] family owns several rental real estate properties in [CITY A] and [CITY B]. These properties are owned by a series of limited liability companies or limited

partnerships that are ultimately controlled by the [X] family. All of the entities maintain a calendar year end.

[COMPANY ONE] is a Tennessee limited liability company. [COMPANY ONE] owns real estate properties for the family of [FAMILY MEMBER A]. The members of [COMPANY ONE], their relationship, and their respective ownership interests are as follows:

<u>Member</u>	<u>Relationship</u>
(1) [FAMILY MEMBER A]	[FAMILY MEMBER]
(2) [S-CORP ENTITY]	[S-CORP]
(3) [FAMILY MEMBER B]	[FAMILY MEMBER]
(4) [FAMILY MEMBER C]	[FAMILY MEMBER]
(5) [FAMILY MEMBER D]	[FAMILY MEMBER]

The members have been assigned points in the [COMPANY ONE] for voting purposes. Voting points are as follows:

[FAMILY MEMBER A]	Class A	[#]
[S-CORP ENTITY]	Class A	[#]
[FAMILY MEMBER B]	Class B	[#]
[FAMILY MEMBER C]	Class B	[#]
[FAMILY MEMBER D]	Class B	[#]
Total		[#]

Rental income profits (as defined in the operating agreement) are allocated in accordance with Article 4, Section 1 of the operating agreement as follows:

1. First, among the members until cumulative profits are equal to cumulative losses for all prior fiscal years;
2. Next, among Class A members until cumulative profits are allocated to Class A members are equal to the preferred return;
3. The balance, 50% to Class A members and 50% to Class B members proportionately based on the number of points held in each class.

The Class A and Class B points are owned as follows:

<u>Class A</u>	<u>Points</u>	<u>Percentage</u>
[FAMILY MEMBER A]	[#]	87.8819%
[S-CORP ENTITY]	[#]	12.1181%
Total	[#]	100.0000%
<u>Class B</u>	<u>Points</u>	<u>Percentage</u>
[FAMILY MEMBER B]	[#]	33.34%
[FAMILY MEMBER C]	[#]	33.33%
[FAMILY MEMBER D]	[#]	33.33%

Total [#]

100.00%

Six Entities Owned at Least 95% by [COMPANY ONE]

[COMPANY ONE] owns at least 95% of the following entities that are doing business in Tennessee:

- [ENTITY A] Owns [REALTY] in [CITY A], TN
- [ENTITY B] Owns [REALTY] in [CITY A], TN
- [ENTITY C] Owns [REALTY] in [CITY A], TN
- [ENTITY D] Owns [REALTY] in [CITY A], TN
- [ENTITY E] Owns [FACILITY] in [CITY C], TN
- [ENTITY F] Owns [REALTY] in [CITY B], TN

[COMPANY ONE] owns 99.9% of [ENTITIES A-E]. [COMPANY ONE] owns the remaining 0.1% of these entities through [COMPANY TWO], a [STATE OTHER THAN TENNESSEE], single member limited liability company. These properties have been placed into separate entities for lender financing purposes. These entities are disregarded as separate entities for federal income tax purposes and are treated as directly owned by [COMPANY ONE]. Therefore, it is asserted that [COMPANY ONE] owns directly 100% of these entities.

[COMPANY ONE] owns 99.78% of [ENTITY F]. An unrelated individual owns the remaining .22%.

Four Entities Owned Less Than 95% by [COMPANY ONE]

[COMPANY ONE] owns less than 95% of the following entities that are doing business in Tennessee:

- [ENTITY G]
- [ENTITY H]
- [ENTITY I]
- [ENTITY J]

The ownership of these entities is described in detail below.

[ENTITY G]

[ENTITY G] is a Tennessee limited partnership which owns the north phase of the [ENTITY K] in [CITY A], Tennessee, and 99% of [ENTITY H] (ownership of this entity is described below).

[ENTITY G] is owned as follows: (Please see Exhibit C for a diagram)

[COMPANY ONE]	10.00%GP
[COMPANY ONE]	33.33%LP
Trust A	56.67%LP

Trust A is a Tennessee trust that was formed to hold certain assets including the ownership interest of [ENTITY G]. Trust A is not a business trust nor a real estate investment trust and is not subject to Tennessee franchise and excise tax. Beneficiaries of Trust A are as follows:

[COMPANY ONE]	75.5232%
Unrelated third party	24.4768%

Therefore, [COMPANY ONE]'s total direct and indirect ownership in [ENTITY G] is:

Direct ownership	43.33%
Indirect ownership through Trust A 56.67% x 75.5232%	<u>42.80%</u>
Total ownership	86.13%

[ENTITY H]

[ENTITY H] is a Tennessee limited liability company that owns the east, south, and west phases of the [ENTITY K] in [CITY A], Tennessee. The lender required this separate entity to be formed for financing reasons.

[ENTITY H] is owned as follows: (Please see Exhibit C for a diagram)

[ENTITY G]	99.00%
[ENTITY L]	1.00%

[ENTITY L] is a Tennessee S-corporation owned 100% by [FAMILY MEMBER A] and was formed because Tennessee did not allow single member LLCs at the time. [ENTITY L] is subject to Tennessee franchise and excise tax and is not relevant to this discussion.

Therefore, [COMPANY ONE]'s total direct and indirect ownership in [ENTITY H] is:

Direct ownership	0.00%
Indirect ownership through [ENTITY G] 99% x 86.13%	<u>85.27%</u>

Total ownership 85.27%

In addition, [FAMILY MEMBER A]'s ownership of [ENTITY H] exclusive of ownership of [ENTITY H] through [COMPANY ONE] is:

Indirect ownership through S corporation 1.00% x 100% 1.00%

[ENTITY M]

[ENTITY M] is a Tennessee limited partnership that owns the [ENTITY N] in [CITY B], Tennessee.

[ENTITY M] is currently owned as follows: (Please see Exhibit D for a diagram)

[COMPANY ONE] 42.50% GP
[ENTITY J] 57.50% LP

[ENTITY J]

[ENTITY J] is a Tennessee limited partnership that owns an interest in [ENTITY I]. And is owned as follows: (Please see exhibit D for a diagram)

[COMPANY ONE] 4.34% GP
[COMPANY ONE] 69.57% LP
Total [COMPANY ONE] 73.91%
Unrelated third party ownership 26.09% LP

Therefore, [COMPANY ONE]'s total direct and indirect ownership in [ENTITY M] is:

Direct ownership 42.50%
Indirect ownership through [ENTITY J] 57.50% x 73.91% 42.50%
Total 85.00%

QUESTIONS

1. Is [COMPANY ONE] exempt from franchise and excise tax as a family-owned non-corporate entity pursuant to T.C.A. §§67-4-2008(a)(8)(A) and 67-4-2015(a)?
2. Are the six entities owned at least 95% by [COMPANY ONE] exempt from franchise and excise tax as family-owned non-corporate entities pursuant to T.C.A. §§67-4-2008(a)(8)(A) and 67-4-2015(a)?
 - a. If the answer to question 2 is no, will the entities be exempt if [FAMILY MEMBER A] is granted 95% of the voting rights for each entity, but the capital and profit interests of each entity remain the same?

- b. If the answer to question 2 is no, will the Commissioner authorize these entities to file a combined franchise and excise tax return with [COMPANY ONE] so that these entities are disregarded for franchise and excise tax purposes?
3. Are the four entities owned less than 95% by [COMPANY ONE] partially exempt from franchise and excise tax to the extent of [COMPANY ONE]'s direct and indirect ownership interest?
- a. If the answer to question 3 is no, will the entities be exempt if [FAMILY MEMBER A] is granted 95% of the voting rights for each entity, but the capital and profit interests of each entity remain the same?
 - b. If the answer to question 3 is no, will the Commissioner authorize these entities to file a combined franchise and excise tax return with [COMPANY ONE] so that these entities are partially disregarded for franchise and excise tax purposes?

RULINGS

1. No, because [COMPANY ONE] does not satisfy the 95% family-owned requirement of Tenn. Code Ann. § 67-4-2008(a)(10).
2. No, because the six entities do not satisfy the 95% family-owned requirement of Tenn. Code Ann. § 67-4-2008(a)(10).
 - a. No
 - b. This sub-issue appears to be a request for a variance and as such a response in the form of a letter ruling is not appropriate.
3. No, Tenn. Code Ann. § 67-4-2008(a)(10) does not provide for partial exemptions.
 - a. No.
 - b. This sub-issue appears to be a request for a variance and as such a response in the form of a letter ruling is not appropriate.

ANALYSIS

1. Tenn. Code Ann. § 67-4-2008(a)(10) exempts from the payment of the excise tax certain family-owned non-corporate entities as follows:
 - (a) There shall be exempt from the payment of the excise tax levied under this part the following:

(10)(A) Any family-owned non-corporate entity where substantially all of the activity of the entity is the production of passive investment income.

(B) For purposes of this subdivision:

(i) “Family-owned” means that at least ninety-five percent (95%) of the ownership units of the entity are owned by members of the family, which means, with respect to an individual, only:

(a) An ancestor of such individual;

(b) The spouse or former spouse of such individual;

(c) A lineal descendent of such individual, of such individual’s spouse or former spouse, or of a parent of such individual;

(d) The spouse or former spouse of any lineal descendent described in subdivision (c); or

(e) The estate or trust of a deceased individual who, while living, was as described in any of the above subdivisions. For purposes of this subdivision, a legally adopted child of an individual shall be treated as the child of such individual by blood.

(ii) “Passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales and exchanges of stock or securities to the extent of any gains therefrom.

Tenn. Code Ann. § 67-4-2008(a)(10).¹

As a limited liability company, [COMPANY ONE] satisfies the non-corporate entity requirement of Tenn. Code Ann. § 67-4-2008(a)(10) (the “Statute”). [COMPANY ONE] does not, however, satisfy the statutory requirement of being “family-owned”. Furthermore, the facts do not reveal whether or not substantially all of [COMPANY ONE]’s activity is the production of passive investment income.

As provided in the Statute, to be “family-owned” means that at least 95% of the ownership units of an entity be owned by members of the family. Being owned by members of the family means, with respect to an individual, certain specified persons that are related by blood or marriage. The one exception to the requirement of being owned by an individual is that certain estates or trusts of deceased individuals are considered to be family members.

[COMPANY ONE] is not “family-owned” because the members of the [X] family do not own at least ninety-five percent (95%) of the ownership units of [COMPANY ONE]. Out of a total of 10,000 ownership units, consisting of both Class A and Class B units, the facts reveal that twelve percent (12%) of those ownership units are owned by [S-CORP. ENTITY]. The individual members of the [X] family own the remaining 88%. This is so despite the fact that [S-CORP ENTITY] is a close corporation whose sole shareholder is [FAMILY MEMBER A]. It is also true despite the fact that [S-CORP. ENTITY] assigned its voting rights or points to [FAMILY MEMBER A].

¹ For purposes of the franchise tax, Tenn. Code Ann. § 67-4-2105(a) provides that persons exempt under Tenn. Code Ann. 67-4-2008 are also exempt from the franchise tax.

As an S-Corporation, [S-CORP. ENTITY] does not qualify as a family member for purposes of the exemption. Therefore, notwithstanding the fact that the remaining owners of [COMPANY ONE] are family members, they own less than the requisite 95% of the [COMPANY ONE] and as such [COMPANY ONE] does not qualify for the exemption.

Finally, while the facts indicate that [COMPANY ONE] owns the six entities that own [VARIOUS TYPES OF REAL PROPERTY], there is no indication that substantially all of the activity of the entity is the production of passive income. While the Statute stipulates that the term “passive investment income” means gross receipts derived from, among other things, rent, to qualify for the exemption [COMPANY ONE] would be required to demonstrate that substantially all of its income came from that source.

2. As noted above, Tenn. Code Ann. § 67-4-2008(a)(10) requires that an entity be family-owned as a prerequisite to qualifying for the exemption. As required by the statute, family-owned means at least ninety-five percent (95%) of the ownership units of the entity are owned by members of a family.

While [COMPANY ONE] owns ninety-nine percent (99%) of the six entities, the entities are nonetheless disqualified from the exemption. As indicated in part one (1) of this ruling, since [COMPANY ONE] has an S-Corporation as a twelve percent (12%) owner it is disqualified from claiming the exemption. It follows that since [COMPANY ONE] is not, in and of itself, family-owned, the six entities that it owns are likewise not family-owned. Furthermore, the portion of Tenn. Code Ann. § 67-4-2008(a)(10) that defines “family-owned” provides that the ninety-five percent (95%) ownership must be held by members of the family. Other than members of a family, the only entity that the statute allows for is certain trusts and estates. There is simply no provision in the law to allow for an entity such as [COMPANY ONE] to qualify as either an individual, an estate or a trust. Therefore, the six entities owned at least 95% by [COMPANY ONE] do not qualify for the exemption.

a. If [FAMILY MEMBER A] is granted 95% of the voting rights for each entity, but the capital and profits interests of each entity remain the same, the response to issue number 2 will not change.

b. Issue 2(b) appears to be a request for a variance. Letter rulings are not the appropriate vehicle to use when requesting a variance and as such a response to your request in this letter ruling is not appropriate. Tennessee law provides that a taxpayer may petition the commissioner of revenue for a variance. The petition is made pursuant to the provisions of T.C.A. §§ 67-4-2014 and 67-4-2112 and Tenn. Comp. R. & Regs. 1320-6-1-.35.

3. Under Tennessee law, exemptions from taxation are construed against taxpayers. *Kingsport Pub. Corp. v. Olsen*, 667 S.W.2d 745 (Tenn. 1984). Furthermore, exemptions must positively appear and will not be implied. *LeTourneau Sales & Service, Inc. v. Olsen*, 691 S.W.2d 531 (Tenn. 1985). Generally, exemptions will only be allowed when granted in clear and unmistakable terms and will be granted exactly according to those

terms. *Metropolitan Government of Nashville and Davidson County v. Nashville Pi Beta Phi House Corp.*, 407 S.W.2d 197 (Tenn. App. 1966). Tenn. Code Ann. § 67-4-2008(a)(10) does not provide for partial exemptions. That being the case, the precedents from Tennessee courts dictate that no partial exemption can be applied to the four entities owned less than 95% by [COMPANY ONE].

a. If [FAMILY MEMBER A] is granted 95% of the voting rights for each entity, but the capital and profits interests of each entity remain the same, the response to issue number 2 will not change.

b. Issue 2(b) appears to be a request for a variance. Letter rulings are not the appropriate vehicle to use when requesting a variance and as such a response to your request in this letter ruling is not appropriate. Tennessee law provides that a taxpayer may petition the commissioner of revenue for a variance. The petition is made pursuant to the provisions of T.C.A. §§ 67-4-2014 and 67-4-2112 and Tenn. Comp. R. & Regs. 1320-6-1-.35.

Steven B. McCloud
Tax Counsel

APPROVED: Ruth E. Johnson
Commissioner

DATE: 1/11/01