TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 01-06

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

Application of Tennessee franchise and excise tax to a taxpayer who leases warehouse facilities located in Tennessee.

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

The taxpayer is a commercial public warehousing company with facilities in Tennessee and other states in the [UNITED STATES]. As part of their contracts with their customers, they manage and store inventory of their customers in warehouses for which the taxpayer is the tenant of an operating lease. For this service, the taxpayer's customers are billed pursuant to a contract. Many of these contracts call for invoices with detailed amounts for reimbursement of labor costs, rent of the facility, reimbursement of other direct and indirect costs, and the expected profit that the taxpayer is to make. Some contracts, especially the older ones, have only one amount in the bill which is representative of all these amounts. As these contracts come up for renewal, however, it is the taxpayer's intention to convert them to contracts which call for a detailed invoice which contains the allocated rent, labor, reimbursement of direct and indirect costs, as well as the expected profit.

QUESTION

Whether the taxpayer may offset, as subrents, the receipts from customers of its warehouse facilities against the rents that it pays to lease the facility?

RULING

No.

ANALYSIS

Doing business in Tennessee or exercising the corporate franchise in Tennessee is a taxable privilege. Thus, absent certain specified exceptions, all persons doing business in Tennessee are subject to paying Tennessee's franchise and excise taxes. See, T.C.A. § 67-4-2105.

Tennessee's franchise tax is required to be measured based upon no less than "the actual value of the real or tangible personal property owned or used in Tennessee, …" Tenn.Code Ann. 67-4-2108(a). This includes property rented by a taxpayer. *Id.* In cases where property is rented, a taxpayer must include the value of rented property used which is determined by multiplying the net annual rental by a statutory multiple. Tenn. Code Ann. § 67-4-2108(a)(3).

The term "net annual rental" means "the gross annual rental paid by the taxpayer, less the gross annual rental received by the taxpayer for sub-rental." Tenn. Code Ann. § 67-4-2108(a)(D).

Tenn. Comp. R. & Regs. 1320-6-1-.18(2) provides:

> (2) Rentals included in the minimum measure of the franchise tax may be offset by subrentals only to the amount of rentals paid. To qualify as a subrental, the sublessee must have the same rights as the lessee with respect to use of the property.
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> Example (1): A real estate developer is the lessee of a motel building and operates it with rooms available for the use of the guests on a daily basis for a daily charge. The lease payment made by the real estate developer must be included in the minimum measure of the franchise tax with the multiple of 8 applied and without an offset for the payments received from hotel guests.
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> Example (2): Same as (1), except that the real estate developer subleases the entire building to a motel chain which operates it as a motel. The sublease payments received from the motel chain are subrentals to the real estate developer and may be offset against the lease payments included in the real estate developer's franchise tax minimum measure.

The provision of the rule which states what qualifies as subrental clarifies that a taxpayer will only be allowed to offset where there is a true sublease between the taxpayer and a tenant, as distinguished from some other right or privilege. Therefore, unless the

taxpayer can be found to have entered into a sublease with its customer, the amounts paid to the taxpayer by the customer will not be considered as subrental payments.

There are distinctions between a lease and some other right in connection with real property. "A landlord-tenant relationship exists only if the landlord transfers the right to possession of the leased property." *Restate (Second) of Property*, and.& Ten., § 1.2 (1976 Main Vol.). Generally, during the existence of a lease, the tenant is the owner of the premises and entitled to exclusive possession. 51 C.J.S. Landlord and Tenant, S 202(6). *United States v. Anderson County*, 575 F.Supp. 578, affirmed 761 F.2d 1169, certiorari denied 106 S.Ct 248, 88 L.Ed2d 256, (E.D.Tenn. 1983). A "sublease" is a transaction whereby a tenant grants an interest in lease premises that is less than his own, or reserves to himself a reversionary interest in the lease. See, *Ernst v. Conditt*, 390 S.W.2d 703 (Tenn. App. 1965). The distinction between an assignment of a lease and a sublease is that a "sublease" contemplates a reversion, whereas an "assignment" is effective to transfer the whole interest of the lessee in the term without retention by him of any reversion. See, *Murphy v. Reynolds*, 212 S.W.2d 686 (Tenn.App. 1948). "A 'license' is an authority to do a particular act or series of acts on another's land without possessing any estate therein. It is not assignable, and is generally revocable at the will of the licensor." *Barksdale v. Marcum*, 7 Tenn.App. 697, 708 (Ct.App. 1928) (citation omitted).

An analysis of the written contract[1] that the taxpayer has with its customers fails to reveal any transfer of any right to possession of property by the taxpayer to the customer. While Section 4 of the contract specifies that a particular warehouse facility will be used, it also indicates that a different, unspecified, location may be used, in addition to or in lieu of, the identified facility. Moreover, while Section 4.4 of the contract provides that the taxpayer's customers may visit the facility from time to time, there is no indication whatsoever that the customer is being granted any interest in the lease premises.

As the tenant of an operating lease, the taxpayer maintains exclusive possession and control of the warehouse facilities. While the contract that the taxpayer's have with its customers may detail amounts for rent, such fact has no bearing on whether the taxpayer enters into subleases with its customers. Instead, the relevant inquiry is whether the taxpayer granted to its customer the right to exclusive possession of the leased premises. Therefore, based on the foregoing, the rents which taxpayer receives from its customers do not constitute subrentals that can be offset against the rentals paid to the taxpayer's landlord.

[1] The taxpayer provided the department with a copy of a redacted contract that it has with one of its customers.

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