

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 02-09**

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 Tenn. Code Ann. § 67-4-2008(10) to an Internal Revenue Code § 368(a)(1)(A) tax-free reorganization wherein a Tennessee corporation merges into a Tennessee limited liability company.

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

A Tennessee corporation with two individual shareholders is taxed as a C corporation for federal income tax purposes. The C corporation owns a warehouse located in Tennessee, which it leases to its tenants. In December 2000, the two shareholders of the C corporation form a new Tennessee limited liability company (Newco, LLC) (hereinafter "Newco") with ownership interest being the same as the C corporation. In accordance with Treasury Reg. § 301.7701-2(b)(2) (the "check the box" regulations), Newco elects to be taxed as a corporation for federal income tax purposes. Nominal contributions ([AMOUNT]) are made to Newco. Both the C corporation and Newco's tax years are calendar years. After December 2000, the C corporation merges into Newco in accordance with Tenn. Code Ann. § 48-21-102. For federal income tax purposes, the merger will be a tax-free reorganization in accordance with Internal Revenue Code § 368(a)(1)(A) based on the rationale of IRS PLR's 199947034, 199942009, and 200007011. The result of the transaction is that the entity owning and leasing the real estate changes from a Tennessee corporation to a Tennessee limited liability company. Effective January 1, 2001, Newco meets all of the requirements to be exempt from Tennessee Franchise and Excise tax in accordance with Item 10 of Tenn. Code Ann. § 67-4-2008.

QUESTIONS

1. Presuming that effective January 1, 2001, Newco otherwise meets the requirements to be an entity exempt from Tennessee Franchise, Excise taxes in accordance with Tenn. Code Ann. § 67-4-2008(10), does the merger in year 2000 otherwise preclude Newco from being exempt under the same statute in 2001?
2. If the transfer of assets and liabilities from the C corporation to Newco is tax free for federal income tax purposes under IRC § 361(a) (as a statutory merger under IRC § 368(a)(1)(A)), will the transfer also be treated as tax-free for Tennessee excise tax purposes?
3. Would the answers to questions 1 and 2 be different if both the corporation and Newco are taxed as S corporations for federal income tax purposes?

RULINGS

1. No. If the merger occurred in 2000 and the entity otherwise met the requirements for the exemption, the merger would not preclude the entity from qualifying for the exemption in 2001. However, Newco's election to file as a corporation for federal income tax purposes will preclude Newco from satisfying the requirements for the exemption.
2. Yes.
3. If the Tennessee corporation were, for federal tax purposes, taxed as an S corporation the answers to questions one (1) and two (2) above would not change. If, however, Newco were taxed as an S corporation, Newco would not qualify for the exemption found at Tenn. Code Ann. § 67-4-2008(10).

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

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). Nevertheless, in accordance with Tenn. Code Ann. § 67-4-2008(10), an entity will qualify for the exemption if: 1) the entity is family-owned; (2) the entity is a non-corporate; and (3) substantially all of the activity of the entity is the production of passive investment income.

While the question asks the Commissioner to presume that Newco otherwise meets the requirements to be an exempt entity in accordance with T.C.A. § 67-4-2008(10), the facts indicate that Newco will not meet the requirements. Newco's election to file as a corporation for federal income tax purposes will preclude Newco from satisfying the requirements for the exemption.

With respect to an entity's classification for Tennessee excise tax purposes, T.C.A. § 67-4-2007(d) provides as follows:

... a business entity shall be classified as a corporation, partnership, or other type business entity, consistent with the way the entity is classified for federal income tax purposes, and subject to tax in accordance with this part. Notwithstanding any provision of law to the contrary, entities that are disregarded for federal income tax purposes, except for limited liability companies whose single member is a corporation, shall not be disregarded for Tennessee excise tax purposes.

T.C.A. §§ 67-4-2007(d).²

Furthermore, Tenn. Code Ann. § 48-211-101 provides, in pertinent part, as follows:

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.

² T.C.A. § 67-4-2106(c) is the franchise tax provision that mirrors the excise tax provision.

For purposes of all state and local Tennessee taxes, a foreign or domestic LLC shall be treated as a partnership or an association, taxable as a corporation as such classification is determined for federal income tax purposes. . . .

Tenn. Code Ann. § 48-211-101.

If Newco elects to be taxed as a C corporation, Tennessee will recognize such election and treat Newco as a C corporation for state tax purposes. As a result, Newco will be treated as a corporate entity and thus fail to qualify for the exemption contained in Tenn. Code Ann. § 67-4-2008(10).

With that said, if Newco chooses not to file as a corporation for federal income tax purposes and does satisfy each of the requirements of T.C.A. § 67-6-2008(10), there is no reason that the merger would act to preclude Newco from being exempt in tax year 2001.

2. Tennessee adopts federal taxable income as the starting point for calculating Tennessee taxable income. See, Tenn. Code Ann. §§ 67-4-2007 and 67-2-2006. There is no provision in Tennessee's franchise, excise tax law that would require the C corporation's transfer of assets and liabilities to Newco be treated in a manner that is inconsistent with the federal income tax treatment. Thus, assuming the merger will be tax-free for federal income tax purposes, the merger will be treated as tax-free for Tennessee excise tax purposes as well.

3. If the Tennessee corporation or Newco were, for federal tax purposes, taxed as an S corporation the answers to questions one (1) and two (2) above would not change.

For purposes of Tennessee's excise tax, a business entity taxed as an S corporation for federal income tax purposes will be treated and taxed as a C corporation. See, Tenn. Code Ann. § 67-4-2006(a)(2). It follows that if Newco is taxed as an S corporation Tennessee will not recognize the S status and will instead treat Newco as a C corporation. As a result, Newco will be recognized as a corporate entity and thus fail to qualify for the exemption contained in Tenn. Code Ann. § 67-4-2008(10).

Steven B. McCloud
Tax Counsel

APPROVED: Ruth E. Johnson
Commissioner

DATE: April 8, 2002