

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 06-08**

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

The deductibility from annual rent of certain expenses in the computation of the value of rented real property for franchise tax purposes.

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 retroactive revocation of the ruling must inure to his detriment.

FACTS

[TAXPAYER] is a corporation engaged in [A BUSINESS]. The Taxpayer rents substantially all of its office space from two individual shareholders pursuant to a lease agreement (the "Lease"). The rental rate is \$10,000 monthly or \$120,000 annually. The Lease specifies that the lessor is responsible for payment of utilities, taxes, janitorial services, maintenance and interest charges. The Taxpayer's only responsibility is for the annual rental payment of \$120,000.

QUESTION

In the computation of the value of rented real property for franchise tax purposes, may the Taxpayer deduct from net annual rent the expenses described under the facts presented?

RULING

The Taxpayer may not deduct from net annual rent the expenses described under the facts presented.

ANALYSIS

Tenn. Code Ann. § 67-4-2108(a)(1) provides that the minimum measure of the franchise tax shall in no case be less than the actual value of the real or tangible property owned or used in Tennessee. Real property "used in Tennessee" includes real property that is rented by the taxpayer; in the case of rented real property, the value of the rented property is determined by multiplying the "net annual rental" times eight (8). Tenn. Code Ann. § 67-4-2108(a)(3). "Net annual rental" means the gross annual rental paid by the taxpayer, less the gross rental received by the taxpayer for sub-rental. Tenn. Code Ann. § 67-4-2108(a)(6)(D). Payments to a lessor "as part of rent, or in lieu of rent" are considered rent. *Id.* Tenn. Code Ann. § 67-4-2108(a)(6)(D) does not define the term "rent," but payments such as interest, taxes, insurance and repairs shall be treated as rent if such items "would have been paid by the lessor if the lease contract or other agreement had not specifically provided that they be paid by the lessee."¹ *Id.*

Tenn. Comp. R. and Regs. 1320-6-1-.28(2)(c) ("Rule 28") provides that "annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer for the use of the property. Annual rent includes any amount payable for the use of the property, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise. Additionally, Rule 28, Section (2)(c)(.2), provides that annual rent also includes "[a]ny amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated,

¹ Identical language is used in Tenn. Code Ann. § 67-4-2111(c)(1) with respect to the computation of net annual rent for purposes of determining the apportionment formula property factor.

the amount of rent shall be determined by consideration of the relative values of the rent and the other items.”

More precisely, Tenn. Code Ann. § 67-4-2108(a)(6)(D) provides for the inclusion in annual rent of certain expenses such as interest, taxes, insurance and repairs, when paid by the lessee under the terms of the lease agreement. Importantly, Tenn. Code Ann. § 67-4-2108(a)(6)(D) does not allow the deduction from annual rent of such expenses. Similarly, Rule 28 discusses in greater detail the inclusion of certain expenses in the computation of annual rent, but does not allow any deduction of expenses.

As noted above, Rule 28, Section (2)(c)(.2), states that annual rent includes “any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items.” (Emphasis added.) In other words, Rule 28, Section (2)(c)(.2), requires the inclusion in annual rent of amounts payable as additional rent, unless the amount was actually paid as a service charge.

Read in isolation, the final sentence of Rule 28, Section (2)(c)(.2), may appear to indicate that the lessee is permitted to deduct from annual rent the value of expenses such utilities or janitor services, even when such expenses are the sole responsibility of the lessor and are not specifically charged to the lessee. The reasoning is ostensibly that the lump sum rental amount due under the lease reflects the cost of such expenses to the lessor, even though the lease obligates the lessor to pay the expenses.

The final sentence must, however, be read in conjunction with the rest of Rule 28, Section (2)(c)(.2). See *McLane Co., Inc. v. State*, 115 S.W.3d 925, 928 (Tenn.Ct.App. 2002) (quoting *Tidwell v. Servomation-Willoughby Co.*, 483 S.W.2d 98 (Tenn.1972)) (emphasizing that the meaning of a statute is to be determined not from the special words in a single sentence but from the statute taken as a whole).

Read in context, the final sentence simply functions to clarify the exception to the requirement that certain additional payments must be included in annual rent. Rule 28, Section (2)(c)(.1), provides that, in the computation of annual rent, the lessee must first include the amount of rent payable under the lease agreement. Rule 28, Section (2)(c)(.2), requires the lessee to then add to annual rent any amount “payable as additional rent or in lieu of rents.” (Emphasis added.) Such amounts include interest, taxes, insurance, repairs or any other items that are required to be paid by the terms of the lease. Rule 28, Section (2)(c)(.2), goes on to state, however, the lessee must not include in this additional amount any amounts “paid as service charges, such as utilities, janitor services, etc.” (Emphasis added.) The final sentence of Rule 28, Section (2)(c)(.2) (“If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items”), simply serves to explain how the lessee is to proceed if the lessee is specifically required by the lease

agreement to pay additional amounts, but it is unclear what portion of the additional amounts relate to excludible service charges.

To illustrate, assume that a lease requires the lessee to pay a monthly set base rental amount, as well as the lessee's proportionate share of monthly utility charges and real estate tax increases, both as additional rent. Each month, the lessor determines the lessee's proportionate share of these additional items, and sends the lessee an invoice that does not separately list the amount of each additional item. Assume further that the lessor fails to keep adequate records. The lessee would be required by the terms of the lease to pay an amount as additional rent, but the charges would be unsegregated. The lessee would be unable to separate the charges, due to the lessor's lack of records. In this case, the lessee would determine the amount to exclude from the addition to annual rent by taking into consideration the relative value of the rent and each of the additional charges.

In the Taxpayer's case, the Lease simply requires the Taxpayer to pay a lump sum rental amount. The Lease does not require the Taxpayer to pay any amounts as additional rent or in lieu of rent, nor is the Taxpayer required to pay any service charges. Accordingly, the Taxpayer will compute its annual rent by including the amount payable as rent under the terms of the Lease, or \$120,000. The Taxpayer has paid no additional amounts, so no further additions are made to annual rent. Because the Taxpayer has no additional amounts to include in annual rent, the final sentence of Rule 28, Section (2)(c)(.2), does not function to exclude any expenses from the computation. The Taxpayer's annual rent for franchise tax purposes is therefore \$120,000.

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APPROVED: Loren L. Chumley
Commissioner of Revenue

DATE: 4/7/06