

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 11-43**

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

Whether a limited liability company that is wholly owned by a traditional individual retirement account is exempt from the Tennessee franchise and excise taxes under TENN. CODE ANN. § 67-4-2008(a)(11) (Supp. 2010).

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 the taxpayer's detriment.

FACTS

[INDIVIDUAL] is the owner and beneficiary of a traditional individual retirement account (the "IRA") that was formed as a custodial account in accordance with 26 U.S.C.A. § 408(h).¹ The assets of the IRA are held by [NAME REDACTED] (the "Trust Company") as custodian for the benefit of [INDIVIDUAL].

[INDIVIDUAL] desires to invest IRA funds in residential rental properties located in Tennessee. Applicable federal income tax laws and regulations require that all such real estate be held in a single member limited liability company owned by the IRA. Accordingly, [NAME REDACTED] (the "Taxpayer"), a [STATE OF ORGANIZATION] limited liability company, was formed to effect the purchase of the residential rental properties. The Trust Company, as custodian for the benefit of [INDIVIDUAL], is the sole member of the Taxpayer.

[INDIVIDUAL], as owner and beneficiary of the IRA, will direct the Trust Company to contribute IRA funds to the Taxpayer. The Taxpayer will then purchase residential rental properties located in Tennessee.² The Taxpayer's income will derive entirely from rents collected with respect to such residential rental properties.

QUESTION

Is the Taxpayer exempt for purposes of the Tennessee franchise and excise taxes as a family-owned noncorporate entity under TENN. CODE ANN. § 67-4-2008(a)(11) (Supp. 2010)?

RULING

The determination of whether the Taxpayer is exempt for Tennessee franchise and excise tax purposes pursuant to TENN. CODE ANN. § 67-4-2008(a)(11) (Supp. 2010) is made on a year-by-year basis. If the Taxpayer substantiates that at least 66.67% of its gross receipts in the taxable year for which the exemption is claimed derive from passive investment income, the Taxpayer will be exempt from the Tennessee franchise and excise taxes with respect to that taxable year.

¹ 29 U.S.C.A. § 408(a) (West 2011) defines the term "individual retirement account" as "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries," provided that the trust's governing document complies with certain statutory requirements. 29 U.S.C.A. § 408(h) provides that, for federal income tax purposes, a custodial account will be "treated as a trust if the assets of such account are held by a bank ... or another person who demonstrates ... that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account described in" 29 U.S.C.A. § 408(a).

² The Taxpayer has confirmed that all such properties are classified as residential real estate for purposes of the Tennessee property tax.

ANALYSIS

The Taxpayer is exempt for purposes of the Tennessee franchise and excise taxes as a family-owned noncorporate entity under TENN. CODE ANN. § 67-4-2008(a)(11) (Supp. 2010) with respect to taxable years in which at least 66.67% of its gross receipts in the taxable year for which the exemption is claimed derive from passive investment income.

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of certain taxpayers doing business within Tennessee, pursuant to TENN. CODE ANN. § 67-4-2007(a) (Supp. 2010). Tennessee also imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of a taxpayer doing business in Tennessee, pursuant to TENN. CODE ANN. §§ 67-4-2105(a) (Supp. 2010) and 67-4-2106(a) (Supp. 2010).³ Taxpayers subject to the franchise and excise taxes include, but are not limited to, corporations, limited partnerships, and limited liability companies. TENN. CODE ANN. § 67-4-2004(37) (Supp. 2010) (defining the terms “person” and “taxpayer”).

TENN. CODE ANN. §§ 67-4-2007(d) and 67-4-2106(c) provide that, for purposes of Tennessee franchise and excise taxation, a business entity shall be classified as a corporation, partnership, or other type of business entity, consistent with the way the entity is classified for federal income tax purposes. TENN. CODE ANN. §§ 67-4-2007(d) and 67-4-2106(c) further provide that “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 franchise and excise tax purposes. Accordingly, a single member limited liability company that is wholly owned by a corporation and that is disregarded for federal income tax purposes will be disregarded for Tennessee franchise and excise tax purposes as well. All other entities are taxed for franchise and excise tax purposes on a separate entity basis. TENN. CODE ANN. §§ 67-4-2007(e)(1) and 67-4-2106(c).

The Taxpayer is a limited liability company doing business within Tennessee. Because the Taxpayer is not wholly owned by a corporation, it is taxed for franchise and excise tax purposes on a separate entity basis. Accordingly, the Taxpayer will be subject to Tennessee franchise and excise taxation unless an exemption or exclusion from taxation applies.

TENN. CODE ANN. § 67-4-2008(a)(11)(A) exempts from the franchise and excise taxes any “family-owned noncorporate entity,” where “substantially all the activity of the entity” is the production of “passive investment income.”⁴ To come within the scope of the family-owned noncorporate entity exemption under TENN. CODE ANN. § 67-4-2008(a)(11), the following requirements must therefore be met: 1) the Taxpayer must be family-owned; 2) the Taxpayer

³ However, under TENN. CODE ANN. § 67-4-2108(a)(1) (Supp. 2010), the franchise tax base “shall in no case be less than the actual value of the real or tangible property owned or used in Tennessee, excluding exempt inventory and exempt required capital investments.” For purposes of this section, “property” is to be “valued at cost less accumulated depreciation in accordance with generally accepted accounting principles.” TENN. CODE ANN. § 67-4-2108(a)(3).

⁴ TENN. CODE ANN. § 67-4-2105(a) provides an exemption from the Tennessee franchise tax for any entity exempt from the excise tax under the provisions of TENN. CODE ANN. § 67-4-2008.

must be a noncorporate entity; and 3) substantially all of the Taxpayer's activity with respect to the taxable year at issue must be the production of passive investment income.

The determination of whether the Taxpayer is exempt for Tennessee franchise and excise tax purposes pursuant to TENN. CODE ANN. § 67-4-2008(a)(11) is made on a year-by-year basis. Thus, the Taxpayer must satisfy all of the requirements set forth above with respect to each year for which it claims the exemption.⁵

First, the Taxpayer is family-owned. TENN. CODE ANN. § 67-4-2008(a)(11)(B)(i) provides that “‘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 such lineal descendent; or (e) the estate or trust of a deceased individual who, while living, was as described” above. TENN. CODE ANN. § 67-4-2008(a)(11)(B)(v) further provides that “[o]wnership units that are held in trust shall not be treated as owned by members of the family, unless the ownership units are the property of” the type of trust described above, *i.e.*, a testamentary trust. In other words, if all or a portion of the ownership interests in a taxpayer entity are held through a trust, such trust must be the testamentary trust of a deceased member of the family for the exemption to apply.

On an initial note, TENN. CODE ANN. § 67-4-2008(a)(11)(B)(v), which limits trust ownership to testamentary trusts, is not applicable in the Taxpayer's case. Here, all of the ownership interests in the Taxpayer are held through the IRA, a custodial account established for the benefit of [INDIVIDUAL]. A custodial account is not a trust. Rather, a custodial account “is a type of agency account in which the custodian has the obligation to preserve and safekeep the property entrusted to him for his principal.” *In re Estate of Davis*, 589 N.E.2d 154, 162 (Ill. App. Ct. 1992) (quoting BLACK'S LAW DICTIONARY 384 (6th ed. 1990)).⁶ A custodial account is, essentially, a “bailment to be returned intact upon demand.” *Id.* at 161.

The Trust Company, as custodian for the benefit of [INDIVIDUAL], is the sole member of the Taxpayer. However, in the case of a custodial account, the custodian does not have legal title to the property held in the account. Rather, title to the custodial property resides in the principal, *i.e.*, the person for whose benefit the account was established. *See, e.g.*, the Uniform Transfers to

⁵ TENN. CODE ANN. § 67-4-2008(e) requires each person claiming exempt status under TENN. CODE ANN. § 67-4-2008(a)(11) to file such information forms as are required by the Commissioner of Revenue. Additionally, TENN. CODE ANN. § 67-4-2008(f)(1) requires all persons claiming exemption to file an initial exemption application within sixty days of the beginning of the first tax year for which the person claims the exemption. TENN. CODE ANN. § 67-4-2008(f)(2) requires that an application for renewal of exemption be filed by the due date of the return with respect to subsequent years.

⁶ Individual retirement accounts may be created as trusts or as custodial accounts. Importantly, individual retirement accounts created as custodial accounts are not trusts; such accounts are afforded federal tax exempt status by virtue of being treated *as though they were* trusts for purposes of the exemption under 29 U.S.C.A. § 408. A custodial account IRA is not an express trust “because there is no intent to establish a trust.” *In re Estate of Davis*, 589 N.E.2d 154, 162 (Ill. App. Ct. 1992) (paraphrasing *Estate of Davis*, 171 Cal. App. 3d 854, 857 (Cal. Ct. App. 1985)) (holding that the “court's finding that the IRAs be treated as trusts is limited to Internal Revenue Code section 408's purpose of tax deferment.”).

Minors Act, TENN. CODE ANN. § 65-7-113(d) (referring to custodial property as the “property of the minor”). Here, the IRA was established for the benefit of [INDIVIDUAL]; the Trust Company holds the interests in the Taxpayer merely as custodian on behalf of [INDIVIDUAL]. Accordingly, [INDIVIDUAL] is the legal owner of the interests in the Taxpayer.

[INDIVIDUAL] is a “member of the family” because he is the lineal descendent of the hypothetical individual referenced in TENN. CODE ANN. § 67-4-2008(a)(11)(B)(i). Because [INDIVIDUAL] owns 100% of the interests in the Taxpayer, the Taxpayer is family-owned.

Second, the Taxpayer is considered a noncorporate entity for purposes of the exemption because it is a limited liability company.

Third, the Taxpayer has indicated that its sole activity is the production of rental income from residential property.⁷ Provided that the Taxpayer derives income solely from the rental of residential property, substantially all the Taxpayer’s activity is the production of passive investment income. As noted above, TENN. CODE ANN. § 67-4-2008(a)(11)(A) exempts any family-owned non-corporate entity where “substantially all the activity” of the entity is the production of “passive investment income.” The Tennessee Department of Revenue interprets “substantially all the activity” to mean that at least 66.67% of the gross receipts of the entity must be derived from passive investment income.⁸ TENN. CODE ANN. § 67-4-2008(a)(11)(B)(iii) defines the term “passive investment income” as “gross receipts derived from royalties, *rents from residential property* or farm property, dividends, interest, annuities, and sales or exchanges of stock or securities to the extent of any gain therefrom.” (Emphasis added.)

Accordingly, the Taxpayer is exempt for purposes of the Tennessee franchise and excise taxes as a family-owned noncorporate entity under TENN. CODE ANN. § 67-4-2008(a)(11) with respect to taxable years in which at least 66.67% of its gross receipts in the taxable year for which the exemption is claimed derive from passive investment income.

An additional consideration is whether the Employee Retirement Income Security Act of 1974 (“ERISA”) preempts the application of the franchise and excise taxes to the Taxpayer with respect to any year in which less than 66.67% of its gross receipts derive from passive investment income. 29 U.S.C.A. § 1144(a) (West 2011) states that ERISA provisions relating to the protection of employee benefit rights “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) of this title and not exempt under section 1003(b) of this title.” Subject to certain limited exceptions that do not apply here, 29 U.S.C.A. § 1003(a)(1) extends the protections afforded by ERISA to

⁷ TENN. CODE ANN. § 67-4-2008(a)(11)(B)(iv) states that the term “residential property” has “the same meaning as in § 67-5-501, except that ‘residential property’ includes any property leased or rented for residential purposes that includes not more than four (4) residential units.” For Tennessee property tax purposes, TENN. CODE ANN. § 67-5-501(10) (2006) defines the term to mean “all real property that is used, or held for use, for dwelling purposes and that contains not more than one (1) rental unit.”

⁸ The term “substantially all” is not statutorily defined. The Tennessee Department of Revenue has interpreted the term to mean “at least 66.67% percent” based on a prior technical clarification to TENN. CODE ANN. § 67-4-2008(a)(6)(A), which replaced the term “substantially all” with “at least 66.67%.”

“employee benefit plans.”⁹ State laws specifically designed to affect employee benefit plans are accordingly preempted by ERISA. *Mackey v. Lanier Collection Agency & Serv.*, 486 U.S. 825, 829 (1988).

In the Taxpayer’s case, however, there is no preemption by ERISA. Whether or not an individual retirement account is considered an “employee benefit plan” as the term is defined for purposes of ERISA under 29 U.S.C.A. § 1002(3) depends on the type of account; generally speaking, only individual retirement accounts that are used to provide retirement income in the employment context qualify.¹⁰ Traditional and Roth individual retirement accounts are not considered “employee benefit plans” as the term is defined under 29 U.S.C.A. § 1002(3) because they are not established or maintained by an employer to provide retirement income to employees. Additionally, 29 U.S.C.A. § 1051(6) specifically excludes individual retirement accounts from ERISA coverage. Thus, in the event the Taxpayer fails to qualify for the family-owned noncorporate entity exemption under TENN. CODE ANN. § 67-4-2008(a)(11) in a particular taxable year, the Taxpayer will be liable for the franchise and excise taxes with respect to that year.

Kristin Husat
Senior Tax Counsel

APPROVED: Richard H. Roberts
Commissioner of Revenue

DATE: 09/07/2011

⁹ There are three types of employee benefit plans: employee welfare benefit plans, employee pension benefit plans, and plans that are both of the foregoing. 29 U.S.C. § 1002(3). An “employee pension benefit plan” is defined as “any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer ... to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.” 29 U.S.C. § 1002(2)(A).

¹⁰ For example, SEP and SIMPLE IRAs generally fit within this definition because such plans are funded by employers to provide retirement income to employees (typically in the context of self-employment).