TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 11-53

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

The determination of net earnings for Tennessee excise tax purposes with respect to gain arising from a corporate reorganization.

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

Company A ("Parent A"), a foreign corporation with its headquarters outside the United States, is a global company engaged in the research, development, manufacture, marketing and distribution of tangible personal property. Parent A is listed and publicly traded on stock exchanges.

The relevant subsidiaries of Parent A are as follows:

- Company B is a foreign corporate subsidiary of Parent A. Company B does not have nexus with Tennessee and does not file a Tennessee franchise and excise tax return. Company B wholly owns Company I.

- Company I is a foreign entity that is disregarded for federal income tax purposes to its parent, Company B. Company I holds a 50% ownership interest in Company D.

- Company C is a United States corporate subsidiary of Parent A. Company C does not have nexus with Tennessee and does not file a Tennessee franchise and excise tax return. Company C acquired a 50% ownership interest in Company D in mid-2009.

- Company D is a foreign company domesticated into the United States as a Delaware limited liability company (an "LLC"). Until the 2010 restructuring transaction described below, Company D was classified as a partnership for federal income tax purposes. Company D has nexus with Tennessee and files a Tennessee franchise and excise tax return. Until the restructuring transaction described below, Company D wholly owned Company E.

- Company E is a French "Société par actions simplifiée"[1] that qualifies for federal income tax purposes as a disregarded entity. Company E does not have nexus with Tennessee and does not file a Tennessee franchise and excise tax return.[2]

- Company E owns 100% of Company F, which in turn owns 100% of Company G, which in turn owns 100% of Company H. Companies F, G and H have nexus with Tennessee and file separate Tennessee franchise and excise tax returns.

In order to enter a potential joint venture with an unrelated third party, Company A restructured its ownership of Company D and its subsidiaries. In 2010, pursuant to a Sale and Purchase Agreement, Company D sold its interest in Company E to Company I for a receivable at an amount that is consistent with the estimated fair market value of Company E as of the date of the transaction. Immediately thereafter, all Company D ownership interests held by Company I were redeemed for fair market value. This resulted in Company D becoming a single member LLC. These structural changes shall be collectively referred to in this revenue ruling as the "Transaction."

For federal income tax purposes, the cancellation of Company I's interest in Company D caused Company D's classification as a partnership to terminate. The termination of Company D's partnership status resulted in the distribution of Company D assets and liabilities to its members (*i.e.*, to Company C and Company I). As a single member LLC, Company D is now disregarded for federal income tax purposes to its sole remaining corporate owner, Company C.

In 2011, Company A terminated the negotiations to enter the potential joint venture noted above. Company D does not contemplate entering into any significant asset sales or joint ventures within twelve months of the date of the Transaction.

Based on the applicable provisions of the Internal Revenue Code, the only gain arising from the Transaction that will be computed and reported on Company D's pro forma federal Form 1065 (U.S. Return of Partnership Income), is the following: 1) any gain recognized to the extent that the overall distribution of assets to each partner in liquidation is not done on a pro rata basis; 2) any gain recognized in accordance with I.R.C. § 751(b); and 3) any gain recognized relating to so-called "springing debt."[3]

QUESTIONS

1. With respect to the taxable year in which the Transaction occurs, do the Tennessee excise tax laws conform to the federal income tax treatment of the Transaction, such that

[1] A French Société par actions simplifiée ("SAS") is similar to a limited liability company. Such companies may be classified as disregarded entities for federal income tax purposes, in accordance with Treas. Reg. § 301.7701-1 *et seq.*

[2] The taxpayer has indicated that, during a prior audit of Company D, the Department instructed Company D to exclude Company E from its franchise and excise tax return.

[3] "Springing debt" can generally be described as debt that ceases to be disregarded; "disregarded debt" is debt that is not recognized for federal income tax purposes. *See, e.g.*, P.L.R. 201021002 (May 28, 2010).

Company D is not required to include any gain from the Transaction in the computation of its Tennessee net earnings that is not recognized for federal income tax purposes?

2. For Tennessee excise tax purposes, does TENN. CODE ANN. § 67-4-2006(b)(1)(I) (Supp. 2010) require Company D to include any gain from the Transaction that is not recognized currently for federal income tax purposes in the computation of its Tennessee net earnings, either with respect to the taxable year in which the Transaction occurs or with respect to subsequent taxable years?

3. For Tennessee excise tax purposes, with respect to the taxable year in which the Transaction occurs, will Company D include in its Tennessee net earnings any gain from the Transaction that is attributable to Company E?

RULINGS

1. With respect to the taxable year in which the Transaction occurs, Company D is not required to include any gain arising from the Transaction in the computation of its Tennessee net earnings that is not recognized for federal income tax purposes.

2. With respect to the Transaction, the only related gain that Company D may be required to add to net earnings is gain resulting from the subsequent sale by Company C or Company I of an asset distributed by Company D to either of these entities upon the termination of Company D's partnership status, but only if such subsequent sale occurs within twelve months of the date of distribution.

3. For Tennessee excise tax purposes, with respect to the taxable year in which the Transaction occurs, Company D will not include in its Tennessee net earnings any gain from the Transaction that is attributable to Company E.

ANALYSIS

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons, as defined under TENN. CODE ANN. § 67-4-2004(37) (Supp. 2010), doing business within Tennessee. 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).[4] Thus, to be subject to the franchise and excise taxes, an entity must come within the scope of the definition of the term "person" as set forth in TENN. CODE ANN. § 67-4-2004(37). Among the entities included in this definition are limited liability companies and corporations.

1. <u>Net earnings and gain arising from the Transaction</u>

[4] 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).

With respect to the taxable year in which the Transaction occurs, Company D is not required to include any gain arising from the Transaction in the computation of its Tennessee net earnings that is not recognized for federal income tax purposes.

The Tennessee excise tax laws do not expressly conform to the federal income tax treatment of a restructuring transaction. Rather, Company D's Tennessee excise tax liability must be computed in accordance with the applicable excise tax provisions.

To compute its Tennessee excise tax liability, Company D must first determine its classification for franchise and excise tax purposes. TENN. CODE ANN. §§ 67-4-2007(d) and 67-4-2106(c) provide that, for Tennessee franchise and excise tax purposes, 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. However, 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 franchise and excise tax purposes. Thus, to be disregarded for franchise and excise tax purposes, an entity must be 1) a single member LLC; 2) wholly owned by a corporation; and 3) disregarded for federal income tax purposes. All other entities will be classified as a partnership or corporation for franchise and excise tax purposes, even if disregarded for federal purposes.

With respect to the taxable year in which the Transaction occurs, Company D is treated as a partnership for franchise and excise tax purposes. Company D is a foreign company, domesticated into the United States as a Delaware LLC, with multiple owners. At the time Company D sold its interest in Company E to Company I, Company D was classified as a partnership for federal income tax purposes. Company D is therefore treated as a partnership for franchise and excise tax purposes with respect to that same taxable period.

TENN. CODE ANN. § 67-4-2006(a)(4) (Supp. 2010) provides in pertinent part that "[i]n the case of a person or taxpayer treated as a partnership for federal tax purposes, or any other person required to file a federal partnership return on a federal form 1065 or any variation of that form, including, but not limited to, limited liability companies," the term "net earnings" or "net loss" is defined as an amount equal to the "amount of ordinary income or loss determined under the applicable provisions of the Internal Revenue Code," as adjusted by TENN. CODE ANN. § 67-4-2006(b)-(c).[5] Ordinary income must include guaranteed payments to partners and capital gains, when such additional items are not already included in ordinary income or loss. TENN. CODE ANN. § 67-4-2006(a)(4)(A). Thus, gain that is recognized for federal income tax purposes and reported in the determination of ordinary business income will be included in net earnings by operation of TENN. CODE ANN. § 67-4-2006(a)(4).

Subsections (b) and (c) of TENN. CODE ANN. § 67-4-2006 require specific addition and subtraction adjustments to federal ordinary business income to arrive at Tennessee net earnings. Neither of these subsections provide, however, for any adjustment to federal ordinary business

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[5] Ordinary income is also reduced by 1) the amount subject to self-employment taxes paid or distributed to each partner or member, and 2) the amount contributed to qualified pension or benefit plans of any partner or member. TENN. CODE ANN. § 67-4-2006(a)(4)(B)-(C). However, such reductions shall not create or increase any net loss. *Id.*

income that would require Company D to include in net earnings gain arising from the Transaction that is not recognized for federal income tax purposes.

Accordingly, with respect to the taxable year in which the Transaction occurs, Company D is not required to include any gain arising from the Transaction in the computation of its Tennessee net earnings that is not recognized for federal income tax purposes.

2. Application of TENN. CODE ANN. § 67-4-2006(b)(1)(I) (Supp. 2010)

With respect to the Transaction, the only related gain that Company D may be required to add to net earnings is gain resulting from the subsequent sale by Company C or Company I of an asset distributed by Company D to either of these entities upon the termination of Company D's partnership status, but only if such subsequent sale occurs within twelve months of the date of distribution.

As discussed in the response to Question #1, Company D will compute its net earnings for Tennessee excise tax purposes starting with its ordinary business income or loss, as shown on its pro forma federal Form 1065 (U.S. Return of Partnership Income), which is then adjusted as provided under TENN. CODE ANN. § 67-4-2006(a)(4) and in accordance with TENN. CODE ANN. § 67-4-2006(b)-(c). In particular, TENN. CODE ANN. § 67-4-2006(b)(1)(I) provides that there shall be added to a taxpayer's net earnings "[a]ny gain not already included in the taxpayer's net earnings or loss on the sale of an asset distributed by the taxpayer to an entity or individual not otherwise subject to the tax imposed by this part, when such asset is sold within twelve (12) months of the date of distribution."[6]

Thus, Company D must include in net earnings any gain that 1) is not already included in Company D's net earnings and that 2) results from the sale of an asset that had been previously distributed by Company D to the entity making the sale. The additional following requirements must also be met: 1) the entity receiving the distributed asset must sell the asset within twelve months of the date of distribution; and 2) the seller must not be subject to the Tennessee excise tax.

Here, under the facts as presented, there has been no subsequent sale of an asset that was distributed by Company D. Accordingly, there is no gain to include in Company D's net earnings under TENN. CODE ANN. § 67-4-2006(b)(1)(I).

As part of the Transaction, Company D distributed assets to Company C and Company I, neither of which is subject to the Tennessee excise tax. For federal income tax purposes, the cancellation of Company I's interest in Company D caused Company D's status as a partnership to terminate; the termination of the partnership resulted in the distribution of Company D assets and liabilities to its members (*i.e.*, Company C and Company I). Neither Company C nor Company I have nexus with Tennessee. However, the facts do not indicate that Company C or Company I

[6] Thus, in such a case, the gain for excise tax purposes is recognized by the taxpayer making the asset distribution rather than the seller. TENN. CODE ANN. § 67-4-2006(b)(1)(I). However, if the taxpayer making the distribution ceases to exist prior to the sale, the gain must be reported, and the tax paid, by the seller as provided under TENN. CODE ANN. § 67-4-2007(f). *Id.*

subsequently sold any of the assets. Accordingly, there is no gain to include in Company D's net earnings.

In the event that Company C or Company I were to sell such an asset within twelve months of the date of distribution, the gain from that sale would be reported on Company D's Tennessee franchise and excise tax return for the period in which the sale takes place.[7]

Therefore, with respect to the Transaction, the only related gain that Company D may be required to add to net earnings is gain resulting from the subsequent sale by Company C or Company I of an asset distributed by Company D to either of these entities upon the termination of Company D's partnership status, but only if such subsequent sale occurs within twelve months of the date of distribution.

3. Gain attributable to Company E

For Tennessee excise tax purposes, with respect to the taxable year in which the Transaction occurs, Company D will not include in its Tennessee net earnings any gain from the Transaction that is attributable to Company E.

TENN. CODE ANN. §§ 67-4-2007(d) and 67-4-2106(c) provide that, for Tennessee franchise and excise tax purposes, 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. However, these sections further state 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. Additionally, TENN. CODE ANN. § 67-4-2007(e)(1) provides in pertinent part that "each taxpayer shall be considered a separate and single business entity for Tennessee excise tax purposes and shall file its Tennessee excise tax return on a separate entity basis reflecting only its own business activities even though it may have filed a consolidated federal income tax return with other members of its unitary group."[8]

Thus, to be disregarded for franchise and excise tax purposes, an entity must be 1) a single member LLC; 2) disregarded for federal income tax purposes; and 3) wholly owned by a corporation. All other entities will be classified as a partnership or corporation for franchise and excise tax purposes, even if disregarded for federal purposes, and must file a separate franchise and excise tax return.

As discussed in the response to Question #1, with respect to the taxable year in which the Transaction occurs, Company D is an LLC that is treated as a partnership for Tennessee franchise and excise tax purposes.

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[7] Following the Transaction, Company D became a disregarded entity for federal income tax purposes. Because it is a single member LLC wholly owned by a corporation (Company C), Company D is now treated as a disregarded entity for franchise and excise tax purposes. *See* TENN. CODE ANN. §§ 67-4-2007(d) and 67-4-2106(c). Accordingly, any gain from the sale of a distributed asset would be reported by Company C on its franchise and excise tax return, which would include Company D's items of income.

[8] TENN. CODE ANN. § 67-4-2106(c) contains a similar provision with respect to the franchise tax.

With respect to the taxable year in which the Transaction occurs, Company E is not classified as a disregarded entity for Tennessee franchise and excise tax purposes. Rather, Company E will be treated as a separate and single business entity. The facts state that Company E is a French SAS that qualifies for federal income tax purposes as a disregarded entity. At the time of the Transaction, Company D wholly owned Company E. With respect to the taxable year in which the Transaction occurs, Company E will not be disregarded for franchise and excise tax purposes, because 1) Company D (the sole owner of Company E) is a limited liability company, not a corporation; and 2) Company E is a French SAS, not a limited liability company.[9]

Because Company E is not disregarded to Company D, and is treated as a separate and single business entity with respect to the taxable year in which the Transaction occurs, Company D will not include in its Tennessee net earnings any gain from the Transaction that is attributable to Company E.

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DATE:	9/22/11

[9] Company E does not have nexus with Tennessee and therefore does not file a Tennessee franchise and excise tax return.