

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 11-63**

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 whose sole asset is an interest in a general partnership is exempt for purposes of the Tennessee franchise and excise taxes under TENN. CODE ANN. § 67-4-2008(a)(11) (2011).

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

[ENTITY #1] and [ENTITY #2] (each, respectively, the "Taxpayer") are [STATE OF ORGANIZATION] limited liability companies. [INDIVIDUAL #1] wholly owns [ENTITY #1]. [INDIVIDUAL #2] wholly owns [ENTITY #2]. The sole asset of [ENTITY #1] is a

[PERCENTAGE] interest in [GENERAL PARTNERSHIP] (the “General Partnership”). The sole asset of [ENTITY #2] is a [PERCENTAGE] interest in the General Partnership.

The General Partnership is engaged principally, for and on behalf of the Taxpayers, in trading commodity futures contracts, which are agreements to buy or sell a particular commodity (*e.g.*, oil, gas, corn, soybeans, and the like) at a given time in the future. In addition, the General Partnership trades futures contracts on financial instruments, as well as other exchange-traded products such as publicly-traded securities, S&P futures, and Treasury bills. However, the majority of the General Partnership’s profits derive from the trading of commodity futures contracts.

QUESTION

Is the Taxpayer exempt for purposes of the Tennessee franchise and excise taxes as a family-owned noncorporate entity pursuant to TENN. CODE ANN. § 67-4-2008(a)(11) (2011)?

RULING

No. The Taxpayer is not exempt for purposes of the Tennessee franchise and excise taxes pursuant to TENN. CODE ANN. § 67-4-2008(a)(11) (2011).

ANALYSIS

Tennessee imposes an excise tax on all persons, as defined under TENN. CODE ANN. § 67-4-2004(37) (2011), doing business within Tennessee. TENN. CODE ANN. § 67-4-2007(a) (2011). 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) (2011) and 67-4-2106(a) (2011).¹ Persons subject to the Tennessee franchise and excise taxes include, but are not limited to, limited liability companies. TENN. CODE ANN. § 67-4-2004(37). General partnerships, however, are not “persons” subject to the Tennessee franchise and excise taxes.² *See id.* Because the Taxpayer is a limited liability company doing business in Tennessee, it will be subject to the Tennessee franchise and excise taxes unless an exemption from taxation applies.

TENN. CODE ANN. § 67-4-2008(a)(11)(A) (2011) 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.”³ To come within the scope of the family-owned noncorporate entity exemption under TENN. CODE ANN. § 67-4-2008(a)(11), the following

¹ Note that, under TENN. CODE ANN. § 67-4-2108(a)(1) (2011), 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).

² The term “general partnership” means “a partnership in which all partners, as defined by state law, are fully liable for the debts of, or the claims against, the partnership.” TENN. CODE ANN. § 67-4-2004(18).

³ 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.

requirements must therefore be met: 1) the Taxpayer must be family-owned; 2) the Taxpayer must be a noncorporate entity; and 3) substantially all of the Taxpayer's activity must be the production of passive investment income.

First, the Taxpayer qualifies as "family-owned" for purposes of the exemption. TENN. CODE ANN. § 67-4-2008(a)(11)(B)(i) defines "family-owned" to mean that at least 95% of the ownership units of the entity are owned by "members of the family." TENN. CODE ANN. § 67-4-2008(a)(11)(B)(i)(c) defines "members of the family" in pertinent part as the "lineal descendants" of a particular individual. The Taxpayer is owned by a single individual, who is a lineal descendant of a particular individual. Because the Taxpayer's single member owns 100% of the ownership units of the Taxpayer, the Taxpayer qualifies as "family-owned" for purposes of the family-owned noncorporate entity exemption.

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

However, as explained below, the third statutory requirement outlined above is not met because the majority of the Taxpayer's income is derived from activities other than the production of passive investment income.

The sole asset of the Taxpayer is an ownership interest in the General Partnership. Because general partnerships are not subject to the franchise and excise taxes, the General Partnership's items of income, loss, deduction, and credit are passed through to the Taxpayer and retain their character in the hands of the Taxpayer. The Taxpayer has indicated that the majority of the General Partnership's profits derive from the trading of commodity futures contracts. If the Taxpayer receives pass-through income from the General Partnership that derives from the trading of commodity futures contracts, such income will be characterized in the hands of the Taxpayer in the same manner in which it is characterized in the hands of the General Partnership.

As noted above, TENN. CODE ANN. § 67-4-2008(a)(11)(A) exempts any family-owned noncorporate 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.⁴ Therefore, the Taxpayer cannot qualify for the exemption under TENN. CODE ANN. § 67-4-2008(a)(11) unless the pass-through income that it receives from the General Partnership is properly characterized as "passive investment income" for purposes of this exemption.⁵

For the reasons set forth below, the Taxpayer's income does not constitute "passive investment income" for purposes of the exemption under TENN. CODE ANN. § 67-4-2008(a)(11).

⁴ 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 technical revision to Tenn. Code § 67-4-2008(a)(6)(A), which replaced the term "substantially all" with "at least 66.67%."

⁵ As discussed above, the Taxpayer will not qualify for the exemption unless at least 66.67% of its gross receipts are derived from passive investment income.

First, commodity futures contracts are not properly characterized as “securities” for purposes of the exemption under TENN. CODE ANN. § 67-4-2008(a)(11). TENN. CODE ANN. § 67-4-2008(a)(11)(B)(iii) defines “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 gains therefrom.” Commodity futures contracts cannot reasonably be characterized as royalties, rents, dividends, interest, or annuities. Thus, such contracts must constitute “securities” for purposes of TENN. CODE ANN. § 67-4-2008(a)(11)(B)(iii) in order for income from the sale or exchange of such contracts to qualify as passive investment income.

A futures contract, roughly speaking, is “a fungible promise to buy or sell a particular commodity at a fixed date in the future.” *Commodity Futures Trading Comm’n v. Erskine*, 512 F.3d 309, 319 (6th Cir. 2008) (quoting *CFTC v. Zelener*, 373 F.3d 861, 862 (7th Cir. 2004)). A commodity futures contract, specifically, is an executory contract for the sale of a commodity executed at a specific point in time, with delivery of the commodity postponed to a future date. *Strobl v. New York Mercantile Exchange*, 768 F.2d 22, 24 (2nd Cir. 1985). Every commodity futures contract has a seller and a buyer; the seller agrees for a price, fixed at the time of contract, to deliver a specified quantity and grade of an identified commodity at a date in the future. *Id.* The buyer agrees to accept delivery at that future date at the price fixed in the contract. *Id.* It is the rare case when buyers and sellers settle their obligations under futures contracts by actually delivering the commodity. *Id.* Rather, they routinely take their respective positions in order to speculate on the future price of the commodity. *Id.* Then, sometime before delivery is due, they offset or liquidate their positions by entering the market again and purchasing an equal number of opposite contracts. *Id.* In this way, their obligations under the original liquidating contracts offset each other. *Id.* The difference in price between the original contract and the offsetting contract determines the amount of money made or lost. *Id.*

Note as well that commodity futures contracts are included in the definition of a “commodity” under the Commodity Exchange Act, 7 U.S.C. § 1a(4) (2010). A “commodity” is defined to include a wide range of agricultural products such as wheat, corn, soybeans, wool, etc., and “all services, rights, and interests in which *contracts for future delivery are presently or in the future dealt in.*” 7 U.S.C. § 1a(4) (emphasis added).

The general definition of “securities” for franchise and excise tax purposes, found under TENN. CODE ANN. § 67-4-2004(46), does not expressly include commodity futures contracts. The term “securities” is defined for purposes of Tennessee franchise and excise taxation as “United States treasury securities, obligations of United States government agencies and corporations, obligations of state and political subdivisions, corporate stock and other securities, participations in securities backed by mortgages held by the United States or state government agencies, loan-backed securities *and similar investments.*” TENN. CODE ANN. § 67-4-2004(46) (emphasis added). Thus, if a commodity futures contract can be characterized as an investment that is similar to the types of securities listed in the definition, it will be treated as a security for purposes of the exemption under TENN. CODE ANN. § 67-4-2008(a)(11).

As explained below, a commodity futures contract is not properly characterized as an investment that is similar to the types of securities listed under TENN. CODE ANN. § 67-4-2004(46).

A commodity futures contract cannot reasonably be described as an investment similar to a governmental or corporate bond. Several of the items listed as examples of securities are most precisely described as governmental or corporate bonds: *i.e.*, United States treasury securities, obligations of United States government agencies and corporations, and obligations of state and political subdivisions. A “bond” is generally defined as a “certificate or evidence of a debt on which the issuing company or governmental body promises to pay the bondholders a specified amount of interest for a specified length of time, and to repay the loan on the expiration date.” BLACK’S LAW DICTIONARY 161 (5th ed. 1979). A commodity futures contract does not represent a promise of a governmental entity or a corporation to pay interest on a debt; it is therefore not a “similar investment” with respect to such items.

A commodity futures contract cannot reasonably be described as an investment similar to “corporate stock and other securities.” Corporate stock represents an ownership or equity interest in a corporation; securities similar to corporate stock would include an ownership or profits interest in a similar enterprise, such as a limited liability company. A commodity futures contract does not in any way represent an ownership or equity interest in a business enterprise.

A commodity futures contract cannot reasonably be described as similar to the remaining two examples included in TENN. CODE ANN. § 67-4-2004(46): *i.e.*, “participations in securities backed by mortgages held by the United States or state government agencies” and “loan-backed securities.” A loan participation generally involves the coming together of multiple lenders to issue a loan to a single borrower; a lead bank originates the loan and then sells participations in the loan to other banks. The loan participants typically receive interest income from the loan. A loan-backed security or mortgage-backed security is similar in that investors purchase security interests in bundles of mortgages or other loans; the investors typically receive income derived from interest payments on such debt obligations. A commodity futures contract does not involve the participation in a loan, nor does it represent a security interest in a debt obligation whereby the holder receives income derived from interest payments.

Accordingly, a commodity futures contract is not properly characterized as an investment that is similar to the types of securities listed under TENN. CODE ANN. § 67-4-2004(46). As a result, commodity futures contracts are not properly considered securities for purposes of the exemption under TENN. CODE ANN. § 67-4-2008(a)(11).

This conclusion is reinforced by numerous decisions in which the courts have held that a commodities futures contract is not a security under the Securities Act of 1933. *SEC v. Commodity Options International, Inc.*, 553 F.2d 628, 632 (9th Cir. 1977); *Glazer v. National Commodity Research and Statistical Service, Inc.*, 547 F.2d 392, 393 (7th Cir. 1977); *McCurnin v. Kohlmeyer*, 340 F. Supp. 1338, 1341-42 (E.D. La. 1972). Note that some courts have recognized that discretionary accounts in commodities futures contracts, as opposed to the futures contracts themselves, may be “investment contracts” and thus “securities” for purposes of the securities acts. *Moody v. Bache & Co., Inc.*, 570 F.2d 523, 526 (5th Cir. 1978). However, the Sixth Circuit Court of Appeals has rejected this position, finding that a discretionary trading account in commodity futures is not a security. *See, e.g., Curran v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 622 F.2d 216 (6th Cir. 1980); *see also Milnarik v. M-S Commodities*, 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).

Additionally, as noted above, commodity futures contracts are regulated under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.* (the “Act”), which does *not* regulate the trading of securities. See 7 U.S.C. § 2 (2010). Significantly, the definition of a “security” for purposes of the Act generally does not include commodity futures contracts. 7 U.S.C. § 1a(30) defines the term “security” as “a security as defined in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C. 77b(a)(1))⁶ or section 3 (a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10))⁷.” Neither of these definitions includes commodity futures contracts.

Second, the Taxpayer is not in receipt of passive income from the General Partnership. As explained above, the General Partnership’s items of income, loss, deduction, and credit retain their character in the hands of the Taxpayer. Thus, to be considered passive income in the hands of the Taxpayer, the income must be passive in the hands of the General Partnership. However, the General Partnership actively *trades* commodity futures contracts, publicly-traded securities, S&P futures, and Treasury bills. Such trading requires far more active participation than the mere acquisition and passive holding of a particular income-producing investment.

Additionally, the formation of a general partnership to actively trade commodity futures contracts creates the presumption that the income derived from such activities is not passive. Under the Tennessee Revised Uniform Partnership Act, TENN. CODE ANN. § 61-1-202(a) (Supp. 2010), the formation of a general partnership results from “the association of two (2) or more persons to carry on as co-owners of a *business* for profit.” (Emphasis added.) Thus, the activities of the General Partnership are presumed to constitute a business. Income resulting from such business activities is not properly characterized as passive.

The Tennessee Supreme Court has stated that that the burden is on the taxpayer to establish entitlement to an exemption, and any well-founded doubt is sufficient to defeat a claimed exemption from taxation. *Am. Airlines, Inc. v. Johnson*, 56 S.W.3d 502, 506 (Tenn. Ct. App. 2000) (citing *Tibbals Flooring Co. v. Huddleston*, 891 S.W.2d 196, 198 (Tenn. 1994); *United Cannery, Inc. v. King*, 696 S.W.2d 525, 527 (Tenn. 1985)). The fact that the General

⁶ 15 U.S.C. § 77b(a)(1) (2010) defines the term “security” as “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

⁷ 15 U.S.C. § 78c(a)(10) (2010) defines the term “security” as “any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”

Partnership's trading activities center upon investments of the type that require active involvement constitutes a well-founded doubt as to the Taxpayer's entitlement to the exemption. Accordingly, income from the sale or exchange of commodity futures contracts does not constitute passive investment income for purposes of TENN. CODE ANN. § 67-4-2008(a)(11).

Therefore, the Taxpayer is not exempt for purposes of the Tennessee franchise and excise taxes pursuant to TENN. CODE ANN. § 67-4-2008(a)(11).

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APPROVED: Richard H. Roberts
Commissioner of Revenue

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