

**TENNESSEE DEPARTMENT OF REVENUE  
REVENUE RULING # 13-22**

**Revenue rulings are not binding on the Department. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.**

**SUBJECT**

The calculation of net earnings or loss for Tennessee excise tax purposes by federally disregarded subsidiaries of real estate investment trusts.

**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**

The Taxpayers are the direct or indirect subsidiaries of real estate investment trusts (“REITs”). Each Taxpayer’s business consists of a form of financing known as “sale-leaseback” in which a company sells its real estate to the Taxpayer in exchange for cash and simultaneously signs a long-term lease with the taxpayer. None of the Taxpayers are owned by captive REITs, as defined by TENN. CODE ANN. § 67-4-2004(7) (2013). While the factual circumstances surrounding each Taxpayer differ, the Taxpayer in each case is a federally disregarded entity that files on the parent REIT’s federal income tax return. Additionally, the Taxpayer in each case is treated as a separate entity for Tennessee franchise and excise tax purposes. The facts can be divided into four scenarios.

*Scenario 1:*

The Taxpayer is a limited partnership owned by two partners. The first partner is a REIT that does not come within the definition of “public REIT” under TENN. CODE ANN. § 67-4-2004(39). The second partner is either a corporation wholly owned by the REIT or a single-member limited liability company (“SMLLC”) whose single member is the REIT. The Taxpayer owns real property in Tennessee, but the partners have no contacts in Tennessee beyond the activities of the Taxpayer.

*Scenario 2:*

The Taxpayer is a corporation wholly owned by a REIT that does not come within the definition of “public REIT” under TENN. CODE ANN. § 67-4-2004(39). The Taxpayer is disregarded to the

REIT for federal tax purposes. The Taxpayer owns real property in Tennessee, but the REIT has no contacts in Tennessee beyond the activities of the Taxpayer.

*Scenario 3:*

The Taxpayer is a limited liability company with two members. The first member is a REIT that does not come within the definition of “public REIT” under TENN. CODE ANN. § 67-4-2004(39). The second member is a corporation wholly owned by the REIT. The Taxpayer owns real property in Tennessee, but the members have no contacts in Tennessee beyond the activities of the Taxpayer.

*Scenario 4:*

The Taxpayer is a limited partnership owned by two partners. The first partner is a public REIT, as defined in TENN. CODE ANN. § 67-4-2004(39) (2013). The second partner is a corporation wholly owned by the public REIT. The Taxpayer owns real property in Tennessee, but the partners have no contacts in Tennessee beyond the activities of the Taxpayer.

## **RULINGS**

1. If the Taxpayer uses a *pro forma* Federal Form 1120-REIT (U.S. Income Tax Return for Real Estate Investment Trusts) as support for its Tennessee franchise and excise tax return, may the Taxpayer apply the dividends paid deduction from Form 1120-REIT, Line 21b, in the computation of its net earnings or loss for Tennessee excise tax purposes?

Ruling: No. If the Taxpayer uses a *pro forma* Federal Form 1120-REIT (U.S. Income Tax Return for Real Estate Investment Trusts) as support for its Tennessee franchise and excise tax return, the Taxpayer may not apply the dividends paid deduction from Federal Form 1120-REIT, Line 21b, in the computation of its net earnings or loss for Tennessee excise tax purposes.

2. Do limited partnerships owned by public REITs, as defined under TENN. CODE ANN. § 67-4-2004(39) (2013), and disregarded for federal tax purposes qualify for the exclusion provided under TENN. CODE ANN. § 67-4-2006(a)(5) (2013) or the exemption provided under TENN. CODE ANN. § 67-4-2019 (2013)?

Ruling: No. Only entities treated as partnerships for federal tax purposes may qualify for the exclusion or exemption provided by TENN. CODE ANN. §§ 67-4-2006(a)(5), -2019. Since the limited partnerships are for federal tax purposes disregarded to public REITs, they are treated for federal tax purposes as divisions of public REITs rather than partnerships.

## **ANALYSIS**

1. Computation of net earnings or loss for Tennessee excise tax purposes

If the Taxpayer uses a *pro forma* Federal Form 1120-REIT (U.S. Income Tax Return for Real Estate Investment Trusts) as support for its Tennessee franchise and excise tax return, the

Taxpayer may not apply the dividends paid deduction from Federal Form 1120-REIT, Line 21b, in the computation of its net earnings or loss for Tennessee excise tax purposes.

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(38) (2013), doing business within Tennessee.<sup>1</sup> For corporations and other persons that file federally on any variant of Federal Form 1120 (U.S. Corporation Income Tax Return), TENN. CODE ANN. § 67-4-2006(a)(1) (2013) defines “net earnings” as “federal taxable income or loss before the operating loss deduction and special deductions provided for in 26 U.S.C. §§ 241, 242 [repealed], 243-347, and as adjusted by subsections (b) and (c).”

The federal dividends paid deduction, defined under I.R.C. § 561, is only allowed in specific circumstances. With respect to REITs, the deduction is applied in the determination of “real estate investment trust taxable income,” which is subject to taxation under I.R.C. § 857(b)(1). This provision imposes the federal corporate income tax on the “real estate investment trust taxable income of every real estate investment trust.” I.R.C. § 857(b)(2) defines “real estate investment trust taxable income” as the taxable income of a real estate investment trust,<sup>2</sup> with certain statutory adjustments. Among these adjustments is the dividends paid deduction. Specifically, I.R.C. § 857(b)(2)(B) allows a REIT the dividends paid deduction, as defined under I.R.C. § 561, in the computation of its federal real estate investment trust taxable income.

Thus, an entity that has filed an election to be a REIT is subject to taxation under I.R.C. § 857(b)(1) with respect to its real estate investment trust taxable income, which is determined by applying the dividends paid deduction. Except in the case of captive REITs,<sup>3</sup> Tennessee’s excise tax laws neither expressly adopt nor disallow the federal dividends paid deduction.<sup>4</sup> Rather, the dividends paid deduction is taken into account in the computation of the REIT’s net earnings or loss for Tennessee excise tax purposes by virtue of the REIT having utilized the deduction at the federal level.

The facts indicate that the Taxpayer is disregarded for federal income tax purposes to its REIT parent, but is treated as a separate entity for Tennessee franchise and excise tax purposes. Since the Taxpayer federally files on its parent’s Federal Form 1120-REIT, which is a variant of Federal Form 1120, TENN. CODE ANN. § 67-4-2006(a)(1) applies to the Taxpayer and dictates that the starting point for calculating the Taxpayer’s net earnings or loss is its federal taxable

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<sup>1</sup> TENN. CODE ANN. § 67-4-2007(a) (2013).

<sup>2</sup> To be a REIT, an entity must meet the requirements of I.R.C. § 856(a) and file an election in accordance with I.R.C. § 856(c)(1).

<sup>3</sup> “Captive REIT” means “an entity with an election in effect under § 856(c)(1) of the Internal Revenue Code, codified in 26 U.S.C. § 856(c)(1), in which any other entity or individual, directly or indirectly, has at least eighty percent (80%) ownership interest by value determined in accordance with generally accepted accounting principles and whose shares are not traded on a national stock exchange.” TENN. CODE ANN. § 67-4-2004(7).

<sup>4</sup> A captive REIT is required to add to Tennessee net earnings or loss “any deduction by a captive REIT for dividends paid, as defined under 26 U.S.C. § 561, that is allowed and taken under 26 U.S.C. § 857(b)(2)(B).” TENN. CODE ANN. § 67-4-2006(b)(1)(O). Note that this requirement does not apply to captive REITs owned by a bank, bank holding company, or a public REIT. *Id.*

income or loss before the operating loss deduction and special deductions provided for in I.R.C. §§ 241 and 243-347.

To determine its net earnings or loss, the Taxpayer must first compute its *pro forma* federal taxable income as though it had filed separately for federal tax purposes. A taxpayer that is federally disregarded but treated as a separate entity for Tennessee franchise and excise tax purposes will compute its net earnings or loss under TENN. CODE ANN. § 67-4-2006 using as support the federal form filed by the parent. However, this does not imply that the taxpayer is treated for Tennessee tax purposes as though it were the same type of entity as the parent. In other words, a taxpayer federally disregarded to a REIT is not itself considered to be a REIT for Tennessee tax purposes. Rather, the taxpayer will simply use the Federal Form 1120-REIT as support in the calculation of its *pro forma* federal taxable income.

Importantly, if the Taxpayer were to report its federal income tax on a separate entity basis, it would not do so as a REIT. To be a REIT, an entity must meet the requirements of I.R.C. § 856(a) and file an election in accordance with I.R.C. § 856(c)(1). Not only has the Taxpayer not filed such an election, it would be unable to do so as a separate entity.<sup>5</sup>

Since the Taxpayer is not a REIT, the Taxpayer would not be able to utilize the dividends paid deduction under I.R.C. § 857(b)(2) in the determination of its federal taxable income on a separate entity basis. The dividends paid deduction is therefore not allowed in the computation of the Taxpayer's *pro forma* federal taxable income. As a result, the dividends paid deduction may not be applied in the computation of the Taxpayer's net earnings or loss for Tennessee excise tax purposes.

## 2. Limited Partnerships and TENN. CODE ANN. §§ 67-4-2006(a)(5), -2019

Limited partnerships owned by public REITs, as defined under TENN. CODE ANN. § 67-4-2004(39) (2013), and disregarded for federal tax purposes do not qualify for the exclusion provided under TENN. CODE ANN. § 67-4-2006(a)(5) (2013) or the exemption provided under TENN. CODE ANN. § 67-4-2019 (2013).

For Tennessee excise tax purposes, TENN. CODE ANN. § 67-4-2006(a)(5) (2013) permits a taxpayer to exclude from net earnings or loss any amounts “distributed either directly or indirectly to a public REIT,” provided that the taxpayer is “treated as a partnership for federal tax purposes.” Additionally, any taxpayer that “directly or indirectly distributes one hundred percent (100%) of its net earnings or net losses to a public REIT” is entirely exempt from the Tennessee excise tax under TENN. CODE ANN. § 67-4-2019 (2013), provided that the taxpayer is “treated as a partnership for federal tax purposes.”

Thus, even if a Taxpayer is owned by a public REIT, to take advantage of the exclusion or exemption under TENN. CODE ANN. §§ 67-6-2006(a)(5), -2019, the Taxpayer must be treated as a partnership for federal tax purposes. In the question presented, the Taxpayers are described as limited partnerships that are disregarded for federal tax purposes. As disregarded entities, such

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<sup>5</sup> In particular, I.R.C. § 856(a)(5) requires that the entity making the REIT election have at least 100 beneficial owners. Here, none of the Taxpayers described have more than two owners.

Taxpayers are not treated as partnerships for federal tax purposes but as divisions of the public REITs.<sup>6</sup>

Since such federally disregarded Taxpayers are not treated as partnerships for federal tax purposes, they cannot qualify for the exclusion or exemption under TENN. CODE ANN. §§ 67-4-2006(a)(5), -2109 even if owned by a public REIT.

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APPROVED: Richard H. Roberts  
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<sup>6</sup> Treas. Reg. § 301.7701-2 clarifies the federal treatment of various business entities, stating that “[a] business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership,” but that “[a] business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.”