

**TENNESSEE DEPARTMENT OF REVENUE  
REVENUE RULING # 14-07**

**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**

Application of the definitions of “captive REIT” and “public REIT” for purposes of the Tennessee franchise and excise taxes.

**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 issues presented in this ruling concern a complex real estate investment structure consisting of multiple affiliated real estate investment trusts (“REITs”) and limited liability companies (“LLCs”). The ownership structure, described below, is also illustrated on Appendix A and Appendix B.

The ultimate parent company (“PTP”) is a limited liability company that is classified as a publicly traded partnership for federal income tax purposes, pursuant to I.R.C. § 7704.<sup>1</sup> For purposes of Rulings 4 through 6, however, PTP is assumed to be wholly-owned by a Public REIT as defined in TENN. CODE ANN. § 67-4-2004(39). PTP files reports with the Securities and Exchange Commission, and its shares are traded on a national securities exchange. PTP’s connection with Tennessee is limited to its direct and indirect ownership of subsidiaries that own real property in Tennessee. PTP directly owns stock in two subsidiary corporations: REIT A and REIT B. The taxpayer asserts that PTP is not subject to Tennessee franchise and excise taxation.

REIT A is a real estate investment trust, properly qualified as such pursuant to I.R.C. § 856.<sup>2</sup> PTP owns approximately a 10% interest in REIT A, with the remaining 90% of REIT A shares owned by public investors. While REIT A shares are owned by members of the general public, the shares are not listed on a national securities exchange, but rather are traded privately. REIT A conducts no business activities in Tennessee on its own account. REIT A’s contacts with

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<sup>1</sup> (West, Westlaw through P.L. 113-93 (excluding P.L. 113-79)).

<sup>2</sup> (West, Westlaw through P.L. 113-93 (excluding P.L. 113-79)).

Tennessee are limited to indirect ownership of lower tier entities that own real property in Tennessee.

REIT B is a real estate investment trust, properly qualified as such pursuant to I.R.C. § 856. PTP owns approximately a 99% interest in REIT B. The remaining 1% interest in REIT B is owned by outside investors who are unaffiliated with PTP (but who may own minority interests in PTP). REIT B shares are not listed on a national securities exchange, and its shares, to the extent they are traded, are sold in private offerings. REIT B owns real property located in Tennessee and direct and indirect interests in lower tier entities that also own real property in Tennessee. REIT B is subject to Tennessee franchise and excise taxation.

PTP also has indirect interests in the following other entities through its ownership interests in REIT A and REIT B.

LLC 1 is a limited liability company that is classified as a partnership for federal income tax purposes. Its activities are limited to owning an approximately 99% interest in REIT C. REIT A owns an approximately 99% membership interest in LLC 1, and REIT B owns an approximately 1% membership interest in LLC 1. The purpose of LLC 1 is to provide a vehicle by which investors in both REIT A and REIT B may own an interest in REIT C. The taxpayer asserts that LLC 1 is not subject to Tennessee franchise and excise taxation.

REIT C is a real estate investment trust, properly qualified as such pursuant to I.R.C. § 856. LLC 1 owns approximately a 99% interest in REIT C. Outside investors own the remaining 1% of the shares of REIT C. REIT C directly owns real property in Tennessee and indirectly owns real property in Tennessee through one or more federally disregarded limited liability companies of which it is the sole member. REIT C is subject to Tennessee franchise and excise taxation.

LLC 2 is a limited liability company that is classified as a partnership for federal income tax purposes. REIT B and REIT C each individually own approximately a 30% interest in LLC 2. The remaining 40% of LLC 2 is owned by unrelated third party investors. LLC 2 owns real property in Tennessee and is subject to Tennessee franchise and excise taxation. LLC 2 is also the single member of one or more limited liability companies that own property in Tennessee and are disregarded to LLC 2 for federal income tax purposes.

## **RULINGS**

1. Are REIT B and REIT C captive REITs pursuant to TENN. CODE ANN. § 67-4-2004(7) (2013)?

Ruling: Yes. Both REIT B and REIT C are captive REITs pursuant to TENN. CODE ANN. § 67-4-2004(7) (2013), because both have federal REIT elections in effect, are at least 80% owned by another entity, and do not have their shares traded on a national exchange.

2. Do REIT A and REIT B qualify as public REITs pursuant to TENN. CODE ANN. § 67-4-2004(39) (2013)?

Ruling: No. Neither REIT A nor REIT B qualify as public REITs pursuant to TENN. CODE ANN. § 67-4-2004(39) (2013), because their shares are not traded on a national securities exchange registered with the SEC or a regulated national securities exchange of a foreign country.

3. Is LLC 2 part of a captive REIT affiliated group pursuant to TENN. CODE ANN. § 67-4-2004(8) (2013)?

Ruling: No. LLC 2 is not part of a captive REIT affiliated group.

4. Assuming that REIT B is determined to be a captive REIT and PTP is owned by a public REIT, is REIT B subject to the rules under TENN. CODE ANN. §§ 67-4-2006(b)(1)(O), -2007(e)(3), -2114(d) (2013) requiring a captive REIT to file on a combined basis with its captive REIT affiliated group and to increase net earnings by any federally recognized dividends paid deductions?

Ruling: No. REIT B is exempt from the rules under TENN. CODE ANN. §§ 67-4-2006(b)(1)(O), -2007(e)(3), -2114(d) (2013) requiring a captive REIT to file on a combined basis with its captive REIT affiliated group and to increase net earnings by any federally recognized dividends paid deductions, because REIT B is at least 80% owned, indirectly, by a public REIT.

5. Assuming that REIT C is determined to be a captive REIT and PTP is owned by a public REIT, is REIT C subject to the rules under TENN. CODE ANN. §§ 67-4-2006(b)(1)(O), -2007(e)(3), -2114(d) (2013) requiring a captive REIT to file on a combined basis with its captive REIT affiliated group and to increase net earnings by any federally recognized dividends paid deductions?

Ruling: Yes. REIT C is not exempt from the rules under TENN. CODE ANN. §§ 67-4-2006(b)(1)(O), -2007(e)(3), -2114(d) (2013) requiring a captive REIT to file on a combined basis with its captive REIT affiliated group and to increase net earnings by any federally recognized dividends paid deductions, because REIT C is not at least 80% owned, indirectly, by a public REIT.

6. Assuming that PTP is owned by a public REIT, what are the franchise and excise tax consequences for LLC 2?

Ruling: For all tax periods that PTP is owned by a public REIT, LLC 2's net earnings could be reduced by any amount distributed directly or indirectly to the public REIT.

## ANALYSIS

1. Application of "Captive REIT" Definition

REIT B and REIT C are captive REITs, as defined in TENN. CODE ANN. § 67-4-2004(7) (2013).

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons doing business within Tennessee.<sup>3</sup> Tennessee also imposes a franchise tax at the rate of \$0.25 per \$100, or major fraction thereof, on the net worth of a person doing business in Tennessee.<sup>4</sup>

Persons subject to the Tennessee franchise and excise taxes include, but are not limited to, taxpayers that have elected under federal income tax law to be treated as real estate investment trusts (“REITs”) – such as REIT A, REIT B, and REIT C – and taxpayers that are formed as limited liability companies (“LLCs”) – such as PTP, LLC 1, and LLC 2.<sup>5</sup>

The computation of net earnings subject to the Tennessee excise tax generally depends on the taxpayer’s federal filing status.<sup>6</sup> For taxpayers that are corporations or are classified as corporations for federal tax purposes (including REITs), TENN. CODE ANN. § 67-4-2006(a)(1) 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], 243-247” and as adjusted by TENN. CODE ANN. § 67-4-2006(b) and (c).

The specific adjustments to federal taxable income that a REIT will make in order to compute its Tennessee net earnings depend on whether or not the REIT is classified as a “captive REIT.” In general, a REIT may compute its Tennessee net earnings without adding back the federal deduction for dividends paid;<sup>7</sup> the result is that the REIT’s net earnings are effectively reduced by virtue of the REIT having taken the deduction at the federal level. The benefit of the dividends paid deduction is effectively denied, however, to captive REITs; a captive REIT must add to net earnings the amount of the federal dividends paid deduction taken by the captive REIT on its federal return.<sup>8</sup> Additionally, captive REIT affiliated groups are subject to a special combined filing requirement, discussed below.

“Captive REIT” is defined, for Tennessee franchise and excise tax purposes, as

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,

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<sup>3</sup> TENN. CODE ANN. § 67-4-2007(a) (2013).

<sup>4</sup> TENN. CODE ANN. §§ 67-4-2105(a), -2106(a) (2013). Note that the 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, excluding exempt inventory and exempt capital investments. TENN. CODE ANN. § 67-4-2108(a) (2013).

<sup>5</sup> TENN. CODE ANN. § 67-4-2004(38) (2013) (defining “person” to include real estate investment trusts and limited liability companies).

<sup>6</sup> See TENN. CODE ANN. § 67-4-2006(a) (2013).

<sup>7</sup> The deduction for dividends paid is defined under I.R.C. § 561 (West, Westlaw through P.L. 113-93 (excluding P.L. 113-79)) and allowed in the computation of “real estate investment trust taxable income” under I.R.C. § 857(b)(2)(B) (West, Westlaw through P.L. 113-93 (excluding P.L. 113-79)).

<sup>8</sup> See TENN. CODE ANN. § 67-4-2006(b)(1)(O) (requiring taxpayers to increase their net earnings by the amount of “[a]ny deduction by a captive REIT for dividends paid . . . that is allowed and taken”).

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.<sup>9</sup>

The definition of “captive REIT” thus applies to any entity that (1) is a REIT, (2) is at least 80% owned by one entity or individual, and (3) is not publically traded on a qualifying exchange.<sup>10</sup>

Both REIT B and REIT C come within the scope of this definition and are therefore properly considered captive REITs for Tennessee franchise and excise tax purposes. First, each have elections in effect under I.R.C. § 856(c)(1)<sup>11</sup> to be treated as REITs. Second, REIT B is approximately 99% (*i.e.*, more than 80%) owned by PTP, and REIT C is approximately 99% (*i.e.*, more than 80%) owned by LLC 1. Finally, neither REIT B nor REIT C has shares traded on a national stock exchange.

Because REIT B and REIT C possess the three statutory attributes of captive REITs, REIT B and REIT C are captive REITs for Tennessee franchise and excise tax purposes.<sup>12</sup>

## 2. Application of “Public REIT” Definition

Neither REIT A nor REIT B are properly considered a public REIT pursuant to TENN. CODE ANN. § 67-4-2004(39), because their shares are not traded on either a national securities exchange registered with the SEC or a regulated national securities exchange of a foreign country.

Publicly traded real estate investment trusts (“public REITs”) enjoy certain benefits for purposes of the Tennessee franchise and excise taxes.<sup>13</sup> A “public REIT” is defined under TENN. CODE ANN. § 67-4-2004(39) as a REIT

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<sup>9</sup> TENN. CODE ANN. § 67-4-2004(7) (2013) (emphasis added).

<sup>10</sup> The language “whose shares are not traded on a national stock exchange” must refer to the shares of the entity being tested for captive REIT status, not that entity’s owners. Otherwise, the statutory definition would read, “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), *and* in which any other entity . . . .” The fact that the drafters used a comma rather than an “and” between the first and second requirements shows that the definition of “captive REITs” possesses a third requirement, namely that the REIT’s “shares are not traded on a national stock exchange.”

<sup>11</sup> (West, Westlaw through P.L. 113-93 (excluding P.L. 113-79)).

<sup>12</sup> The taxpayer has suggested that the REITs described in the facts operate under materially different circumstances from the entities that the General Assembly intended to classify as captive REITs. However, the General Assembly codified a definition of captive REIT that is clear and unambiguous, and we must apply TENN. CODE ANN. § 67-4-2004(7)’s “plain meaning in its normal and accepted use, without a forced interpretation that would limit or expand the statute’s application.” *Walker v. Sunrise Pontiac-GMC Truck, Inc.*, 249 S.W.3d 301, 309 (Tenn. 2008) (quoting *Eastman Chem. Co. v. Johnson*, 151 S.W.3d 503, 507 (Tenn. 2004)). This is true even if the General Assembly’s purpose in enacting this definition was to redress particular abusive practices by particular types of owners. The General Assembly ultimately chose to craft the definition as enshrined in TENN. CODE ANN. § 67-4-2004(7), which encompasses all entities that meet the three statutory requirements. *See James Cable Partners, L.P. v. City of Jamestown*, 818 S.W.2d 338, 341 (Tenn. Ct. App. 1991).

that files with the securities and exchange commission and whose shares are traded on a securities exchange that is either registered as a national securities exchange with the securities and exchange commission . . . or is a national securities exchange of a foreign country and regulated in a substantially similar manner by a foreign financial regulatory authority.

For a REIT to be considered a public REIT, the REIT's shares must be traded on a qualifying securities exchange.

Neither the shares of REIT A nor the shares of REIT B are publicly traded on a qualifying exchange. To the extent that ownership in either REIT A or REIT B is traded, such trading occurs privately and not on a qualifying exchange. The only entity described in the facts whose shares are traded on a qualifying securities exchange is PTP, the common parent of REIT A and REIT B. However, that fact is irrelevant to the determination of whether REIT A and REIT B are considered public REITS.

Since neither REIT A shares nor REIT B shares are traded on a qualifying securities exchange, neither entity is considered to be a public REIT for Tennessee franchise and excise tax purposes.

### 3. Captive REIT Affiliated Groups

LLC 2 is not part of a captive REIT affiliated group and must therefore file a separate Tennessee franchise and excise tax return.

As a general rule, each taxpayer is considered a separate and single business entity for Tennessee franchise and excise tax purposes and must file its Tennessee franchise and excise tax return on a separate entity basis.<sup>14</sup> Captive REIT affiliated groups, however, are required to file on a combined basis.<sup>15</sup>

The term "captive REIT affiliated group" refers collectively to a captive REIT and its majority-owned subsidiaries, specifically all entities "in which the captive REIT, directly or indirectly, has more than fifty percent (50%) ownership interest."<sup>16</sup> However, if the captive REIT is "owned, directly or indirectly, by a bank, a bank holding company, or a public REIT," that captive REIT and its subsidiaries do not constitute a captive REIT affiliated group.<sup>17</sup>

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<sup>13</sup> See *infra* Rulings 4-5.

<sup>14</sup> See TENN. CODE ANN. §§ 67-4-2007(e)(1), -2106(c) (2013).

<sup>15</sup> TENN. CODE ANN. §§ 67-4-2007(e)(3), -2114(d) (2013).

<sup>16</sup> TENN. CODE ANN. § 67-4-2004(8) (2013).

<sup>17</sup> TENN. CODE ANN. § 67-4-2004(8) (2013).

LLC 2 is not a majority-owned subsidiary of a captive REIT. The only captive REITs in the factual scenario presented are REIT B and REIT C, as previously discussed in the response to Ruling 2. While both REIT B and REIT C own significant interests in LLC 2, neither REIT B nor REIT C directly or indirectly holds more than a 50% interest in LLC 2. REIT C holds only a 30% interest in LLC 2, while REIT B directly and indirectly holds a cumulative interest of roughly 30.3% in LLC 2.

Since neither REIT B nor REIT C holds more than a 50% interest in LLC 2, LLC 2 is not part of a captive REIT affiliated group.

#### 4-5. Captive REIT Directly or Indirectly Owned by a Public REIT

Assuming that PTP is wholly-owned by a public REIT, REIT B is not subject to the rules under TENN. CODE ANN. §§ 67-4-2006(b)(1)(O), -2007(e)(3), -2114(d) requiring a captive REIT to file on a combined basis with its captive REIT affiliated group and increase net earnings by any federally recognized dividends paid deductions. REIT C, however, is subject to the captive REIT rules for dividends paid deductions and combined filing.

As discussed above, captive REITs are subject to rules that require the captive REITs to add back the federal dividends paid deduction when computing net earnings<sup>18</sup> and require captive REIT affiliated groups to file franchise and excise tax returns on a combined basis.<sup>19</sup> Neither rule applies, however, to captive REITs that are “owned, directly or indirectly, by a bank, a bank holding company, or a public REIT.”<sup>20</sup>

Viewed within the statutory context of the captive REIT rules, the requirement that the captive REIT be “owned, directly or indirectly, by a bank, bank holding company, or public REIT” requires that the captive REIT be at least 80% owned, directly or indirectly, by such an entity.<sup>21</sup>

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<sup>18</sup> TENN. CODE ANN. § 67-4-2006(b)(1)(O) (requiring captive REITs to add back to net earnings “[a]ny deduction . . . 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) [the federal REIT dividends paid deduction rule].”).

<sup>19</sup> TENN. CODE ANN. §§ 67-4-2007(e)(3), -2114(d).

<sup>20</sup> See TENN. CODE ANN. § 67-4-2006(b)(1)(O) (“[T]his subdivision (b)(1)(O) shall not apply to a captive REIT that is owned, directly or indirectly, by a bank, a bank holding company, or a public REIT.”); TENN. CODE ANN. § 67-4-2004(8) (“[P]rovided, however, that a ‘captive REIT affiliated group’ does not include a group in which the captive REIT is owned, directly or indirectly, by a bank, a bank holding company, or a public REIT.”).

<sup>21</sup> TENN. CODE ANN. §§ 67-4-2004(8), -2006(b)(1)(O) except from the captive REIT rules a captive REIT that “is owned, directly or indirectly, by” certain entities. The quoted language is ambiguous because it fails to specify what amount of ownership is necessary to trigger operation of the statute. It is a well-established principle of Tennessee law that where statutory ambiguity exists, the courts “look to the entire statutory scheme in seeking to ascertain legislative intent,” and that “[s]tatutes ‘in pari materia’ – those relating to the same subject or having a common purpose – are to be construed together.” *Owens v. State*, 908 S.W.2d 923, 926 (Tenn. 1995) (citing *Lyons v. Rasar*, 872 S.W.2d 895, 897 (Tenn.1994)).

Because the intent of the captive REIT rules is to correct issues that arise when a REIT is “captive” to (or, in other words, is at least 80% controlled by) another entity, it is most consistent to infer that the exceptions to these rules

Assuming that PTP is wholly-owned by a public REIT, REIT B is 99% owned indirectly by the public REIT, and therefore is not subject to the add back of the dividends paid deduction or to the combined filing requirement. REIT C, however, is less than 10% owned, directly or indirectly, by the public REIT. Accordingly, REIT C is subject to the add back of the dividends paid deduction and required to file a combined basis with the members of its captive REIT affiliated group.

6. Partnerships Owned by Public REITs

Assuming that PTP is wholly-owned by a public REIT, LLC 2's net earnings may be reduced by any amounts actually distributed, directly or indirectly, to the public REIT. Pursuant to TENN. CODE ANN. § 67-4-2006(a)(5), taxpayers that are treated federally as partnerships deduct from their computation of net earnings any amounts distributed directly or indirectly to a public REIT, provided that each public REIT's name and federal identification number are submitted with the taxpayer's return. So long as LLC 2 properly submits the public REIT's name and federal identification number on a schedule attached to its return, LLC 2's net earnings will be reduced by any amounts distributed directly or indirectly to the public REIT.

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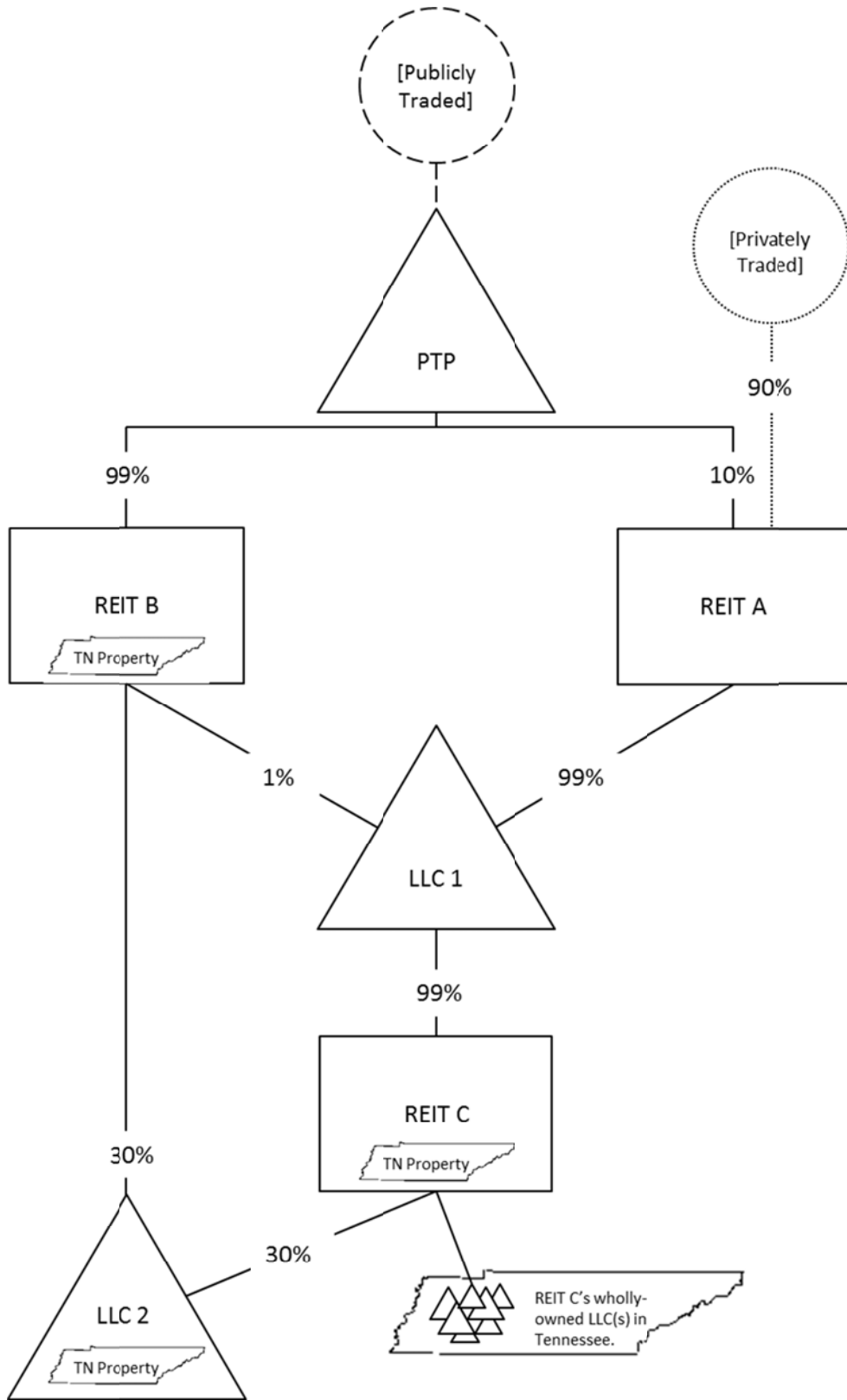
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apply to REITs that are "captive" to banks, bank holding companies, and public REITs. Any other inference would yield peculiar results inconsistent with the captive REIT statutory scheme.



**Appendix A**



**Appendix B**

