TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING # 20-12

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 inclusion of capitalized costs in the Tennessee franchise tax minimum measure.

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 Taxpayer is a homebuilder operating in Tennessee and other states. In Tennessee, the Taxpayer acquires, develops, and sells real property. Presentation of the real property on the Taxpayer's balance sheet varies depending upon its stage of development. Real property with no immediate plan for development is presented as land. Real property under development is presented as work in progress. When the construction of a home is completed and it is available for sale, it is presented as inventory.

Costs incurred to construct a home include the cost of the tangible assets employed in the construction (land, materials, and supplies), as well as certain "soft costs" such as labor, permits, and architectural/engineering services that contribute to the construction of the home. Additionally, the Taxpayer will incur debt, a portion of which is used to finance the cost of construction. Pursuant to generally accepted accounting principles ("GAAP"), many of these soft costs are required to be capitalized, and they are often presented on the Taxpayer's balance sheet in the same line item in which the tangible assets are reported.

RULING

Does the minimum measure of the Tennessee franchise tax under TENN. CODE ANN. § 67-4-2108 (2013) include costs of labor, interest, permits, services, and other non-tangible items that are capitalized and presented on the Taxpayer's balance sheet as components of its inventory and/or work in progress?

> Ruling: Yes. The Taxpayer is a homebuilder and as such is considered to be utilizing its inventory and work in progress for purposes of the franchise tax minimum measure under TENN. CODE ANN. § 67-4-2108 (2013). Therefore, the Taxpayer's capitalized costs are a part of the value of its real and tangible personal property and are included in the franchise tax minimum measure.

ANALYSIS

Tennessee 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, pursuant to TENN. CODE ANN. §§ 67-4-2105(a) (Supp. 2019) and -2106(a) (2013). Persons subject to the Tennessee franchise tax include, but are not limited to, entities such as corporations, limited liability companies, and partnerships.[1]

TENN. CODE ANN. § 67-4-2108(a)(1) (2013) provides that the minimum 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 required capital investments.[2] Property that is under construction and not being utilized, in whole or in part, is also excluded from the minimum measure.[3]

However, the value of property under construction is to be included in the minimum measure if there is actual utilization of the property in whole or in part.[4] Actual utilization of the construction in progress depends upon whether the construction in progress is utilized in the particular business conducted by the taxpayer.[5] Importantly, if the taxpayer is in the business of building and selling real property, all of the construction in progress is treated as being utilized for purposes of the franchise tax minimum measure.[6]

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[1] TENN. CODE ANN. § 67-4-2004(38) (Supp. 2019).

[2] Note that these exclusions do not apply in the Taxpayer's case.

[3] TENN. CODE ANN. § 67-4-2108(a)(3).

[4] TENN. COMP. R. & REGS. 1320-06-01-.18(4) (2016). ("Rule 18(4)"). Rule 18(4) includes the following example:

> Example 2: A corporation is in the business of building and selling homes and the construction in progress will ultimately be for sale or rental. All of the construction in progress is utilized in conducting the business of home building.

[5] *Id.*

[6] *Id.*

TENN. CODE ANN. § 67-4-2108(a)(3), requires that "property" be valued in accordance with generally accepted accounting principles ("GAAP"), at cost less accumulated depreciation. The FASB *Accounting Standards Codification* provides, "The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost, and its determination involves many considerations."[7] Thus, GAAP contemplates the capitalization of soft costs to inventory.

The process of assembling and constructing homes, and the associated costs of these activities, including the soft costs, enhance the value of the real property itself. Accordingly, these soft costs are expenditures and charges incurred to bring the home to its existing condition. In accordance with GAAP, these soft costs should be included in the cost of the home.

One could argue that the reference to "real or tangible personal property" in TENN. CODE ANN. § 67-4-2108(a)(1) allows a taxpayer to bifurcate inventory into tangible and soft cost components and to exclude the latter from the taxpayer's minimum measure simply because such costs do not constitute real or tangible personal property. However, this alternative interpretation of the statute would be inconsistent with GAAP and has been addressed by the courts.

The Tennessee Supreme Court decision in *Crown Enterprises, Inc. v. Woods*,[8] supports the inclusion of capitalized soft costs in the Taxpayer's franchise tax minimum measure. In *Crown Enterprises, Inc.*, a company in the business of constructing and selling homes attempted to exclude the value of homes under construction from the minimum measure, arguing that they were not actually "utilized" under TENN. CODE ANN. § 67-2908 (1976).[9] The Court rejected that argument, holding that because the homes were part of the capital of the company's business, it was utilizing them within the meaning of the statute.[10]

The company had excluded certain expenditures from the minimum measure such as "miscellaneous overhead," which included the cost of the master plan, depreciation of equipment, property taxes, management fees, and supervisory wages.[11] The Court, however, disagreed with the company's exclusion of these expenditures and determined the "miscellaneous overhead" items should be included in the minimum measure.[12] This case is informative here because the "miscellaneous overhead" that the Court concluded should be included in the minimum measure included items that are very similar to the Taxpayer's soft costs.

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[7] FASB *Accounting Standards Codification* at ASC 330-10-30-1, *available at* https://asc.fasb.org/home (last visited October 15, 2020).

[8] 557 S.W.2d 491(Tenn. 1977).

[9] *Id.* at 492. TENN. CODE ANN. § 67-2908 (1976) has been recodified as TENN. CODE ANN. § 67-4-2108(a)(2) (2013).

[10] *Id.*

[11] *Id.* at 492 n.1.

[12] *Id.* at 493-94.

Although TENN. CODE ANN. § 67-4-2108(a)(1) states the minimum measure "shall in no case be less than the actual value of the real or tangible property owned or used in Tennessee" (allowing for certain listed exclusions), and soft costs on a standalone basis are not generally characterized real or tangible property, GAAP requires that soft costs be included in the value of such property under TENN. CODE ANN. § 67-4-2108(a)(3). Thus, the Taxpayer's soft costs are included in the value of the Taxpayer's real or tangible property for purposes of the Tennessee franchise tax minimum measure.

APPROVED:	David Gerregano Commissioner of Revenue
DATE:	11/18/2020