TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 21-09

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. 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 applicability of the Tennessee franchise and excise taxes to an S corporation that is owned by an Employee Stock Ownership Trust organized as an employee benefit plan within the meaning of ERISA.

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

[TAXPAYER] (the "Taxpayer") is an S corporation incorporated under the laws of the State of Tennessee. The Taxpayer established the [TAXPAYER] Employee Stock Ownership Trust (the "Trust") effective [DATE], as a trust under the laws of the State of Tennessee pursuant to and as part of the [NAME] Employee Stock Ownership Plan (the "Plan"), which was executed on [DATE]. The Plan and the Trust together comprise the employee stock ownership plan ("ESOP"). As of [DATE], the ESOP is the sole shareholder of the Taxpayer.

The ESOP was established to allow eligible employees to accumulate capital for their retirement. The Plan is designed and intended to be qualified under section 401(a) of the Internal Revenue Code of 1986, as amended, and to be funded through the Trust.

RULING

Does the Employee Retirement Income Security Act of 1974 ("ERISA"), Pub. L. 93-406, preempt Tennessee franchise and excise taxation of the Taxpayer that is wholly owned by an ESOP that qualifies as an employee pension benefit plan under 29 U.S.C. § 1144(a)(a)(1)?

Ruling: No. ERISA does not preempt Tennessee franchise and excise taxation of the Taxpayer.

ANALYSIS

Tennessee imposes an excise tax at the rate of 6.5% on the net earnings of all persons doing business within Tennessee.[1] 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.[2] "Persons" subject to Tennessee franchise and excise taxes includes, but is not limited to S corporations.[3] With certain limited exceptions, each taxpayer is considered a separate entity and must file its Tennessee franchise and excise tax returns on a separate entity basis.[4] Corporations that elect S corporation status calculate their net earnings in Tennessee without regard to the S election.[5]

Accordingly, Tennessee franchise and excise taxes apply to the Taxpayer as an S corporation doing business in Tennessee unless an exemption or exclusion from taxation applies. As explained below, ERISA does not preempt the application of franchise and excise taxation to the Taxpayer.

The ESOP is covered by ERISA.[6] Subject to certain limited exceptions that do not apply here, 29 U.S.C. § 1003(a)(1) extends the protections afforded by ERISA to "employee benefit plans." There are three types of plans: employee welfare benefit plans, employee pension benefit plans, and plans that are both of the foregoing.[7] Under 29 U.S.C. § 1002(2)(A), an "employee pension benefit plan" is any plan, fund, or program that provides retirement income to employees. The ESOP fits within this definition because it was formed to provide retirement income to employees. Therefore, the ESOP is an employee benefit plan that falls under ERISA protection.

The relevant part of the ERISA preemption provision is stated at 29 U.S.C. § 1144(a), "the provisions of this subchapter and subchapter III shall supersede any and all State laws insofar as they may now or hereafter

[1] TENN. CODE ANN. § 67-4-2007(a) (Supp. 2020).

[2] TENN. CODE ANN. §§ 67-4-2105(a) (Supp. 2020) and -2106(a) (2013).

[3] TENN. CODE ANN. § 67-4-2004(38) (Supp. 2020).

[4] TENN. CODE ANN. §§ 67-4-2106(c) and -2007(d).

[5] TENN. CODE ANN. § 67-4-2006(a)(2) (Supp. 2020).

[6] An ESOP is an IRC § 401(a) qualified defined contribution plan. An ESOP must be designed to invest primarily in qualifying employer securities as defined under IRC § 4975(e)(8) and meet other Internal Revenue Code requirements. ERISA was created to provide federally mandated minimum standards for employee benefit plans. See 29 U.S.C. § 1001(a).

[7] 29 U.S.C. § 1002(3).

relate to an employee benefit plan…" A law relates to an employee benefit plan if it has a connection with or reference to such a plan.[8] Thus, state laws that are specifically designed to affect employee benefit plans are preempted by ERISA.[9] However, when reviewing a claim of preemption, the U.S. Supreme Court begins with the presumption that Congress did not intend to preempt state laws, particularly in areas of traditional state concern.[10]

ERISA preemption is a highly litigated area that has evolved significantly in the years since the Department first issued a letter ruling on whether Tennessee's franchise and excise taxes are preempted by ERISA.[11] As an example, the recent decision of the United States Supreme Court in *Rutledge v. Pharm. Care Mgmt. Ass'n*, 141 S. Ct. 474 (2020), reinforced a line of cases that hold that a state law that merely increases plan costs or has an indirect economic influence on a plan is not preempted by ERISA. *Rutledge* makes clear that Tennessee's franchise and excise taxes—state laws of general application that merely increase plan costs—are not preempted.

The line of cases upholding state tax statutes of general applicability includes the U.S. Supreme Court's ruling in *De Buono v. NYSA-ILA Medical and Clinical Services Fund,* in which the Court held that a state law imposing a gross receipts tax on income of medical centers operated by ERISA funds was not preempted by ERISA.[12] Similarly in *Firestone Tire & Rubber Co. v. Neusser*, the Sixth Circuit Court of Appeals held that a neutral income tax of general application which applies to employees without regard to their status as ERISA participants is not preempted by ERISA.[13] Finally, in *Thiokol Corp. v. Roberts*, the Sixth Circuit Court of Appeals held that a state value added tax that precluded employers from deducting compensation paid to an employee benefit plan was not preempted by ERISA.[14] The mere fact that a statute has some economic impact on an ERISA plan does not invalidate the statute.[15]

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[8] *Self-Insurance Institute of America, Inc. v. Snyder*, 827 F.3d 549, 554 (6th Cir. 2016) (citing *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 96-97 (1983)).

[9] *Mackey v. Lanier Collection Agency & Serv.*, 486 U.S. 825, 829 (1988).

[10] *N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 656 (1995).

[11] Letter Ruling 95-02 (January 19, 1995) stated that, under the particular facts presented, ERISA preempted taxation of a corporate subsidiary owned by an ERISA-covered entity. The analysis relied exclusively on the New York court case *Morgan Guaranty Trust Co. v. Tax Appeals Tribunal of the New York State Dept. of Taxation and Finance*, 587 N.Y.S.2d 252 (N.Y. Ct. App. 1992).

[12] *De Buono v. NYSA-ILA Medical and Clinical Services Fund*, 117 S. Ct. 1747, 1749 (1997).

[13] *See Firestone*, 810 F.2d 550 at 556 (considering three factors: whether the tax constituted a traditional exercise of state authority; whether it affected relations among the principal ERISA entities - the employer, the plan, the plan fiduciaries, and the beneficiaries - or relations between one of these entities and an outside party; and whether it had any more than a tenuous, peripheral effect on a covered plan).

[14] *See Thiokol*, 76 F.3d 751 (utilizing the same factors in *Firestone* and finding that the tax falls within an area of traditional state concern, does not affect relations among the principal ERISA entities, and only has a peripheral effect on an ERISA plan).

[15] *Rebaldo v. Cuomo*, 749 F.2d 133, 139 (2d Cir. 1984) (stating that "if ERISA is held to invalidate every State action that may increase the cost of operating employee benefit plans, those plans will be permitted a charmed existence that never was contemplated by Congress."); *cf. Morgan Guaranty Trust Co. of New York v. Tax Appeals Tribunal of New York State Dept. of Taxation and Finance*, 587 N.Y. S.2d 252, 257 (Ct. App. 1992) (stating that a tax applied directly on gains derived from the sale of plan assets is preempted by ERISA because it is not a "cost of doing business" law.); *but see Sharp v. Caterpillar*, 932 S.W. 2d 230, 238-39 (Tex. Ct. App. 1996) (stating that the "cost of doing business" distinction in *Morgan Guaranty* meant that *Morgan Guaranty* was not persuasive authority when determining if ERISA preempts provisions of a franchise tax law because the provision is a part of a generally applicable tax scheme that only incidentally raises the cost of doing business for some ERISA plans).

Tennessee franchise and excise tax laws are not designed to affect employee benefit plans; instead, they are generally applicable to all persons doing business within Tennessee. Additionally, the franchise and excise tax laws constitute a traditional exercise of state authority.

The connection that Tennessee franchise and excise tax laws have to the Taxpayer's ESOP is that they increase the cost of doing business for the S corporation in which the ESOP is a shareholder. These laws do not apply to the ESOP itself or to the beneficiaries of the ESOP, nor do they apply to the Trust or the Plan.

Although the Taxpayer elected federal pass through status to eliminate its federal tax liability, Tennessee does not recognize passthrough status for franchise and excise tax purposes. Therefore, the Tennessee excise tax is imposed on the S corporation's earnings rather than on the ESOP. Similarly, the Tennessee franchise tax applies to the S corporation's net worth rather than to the value of the ESOP.

In sum, the Tennessee franchise and excise taxes do not apply to the ESOP; they apply to the S corporation doing business in Tennessee. Although taxing the S corporation's earnings and net worth may result in less money flowing from the S corporation to the ESOP, this is only a peripheral effect. As such, these taxes do not "relate to" the ESOP within the meaning of ERISA. Accordingly, ERISA does not preempt Tennessee franchise and excise taxation of the Taxpayer.

APPROVED: David Gerregano
Commissioner of Revenue

DATE: 9/22/2021