

**TENNESSEE DEPARTMENT OF REVENUE
REVENUE RULING #98-33**

WARNING

Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.

SUBJECT

Whether a business trust that is treated as a division of its sole corporate certificate holder for federal income tax purposes will be treated in like manner for Tennessee franchise, excise tax purposes.

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

Corporation X is a Delaware chartered corporation domiciled in [STATE - NOT TENNESSEE] and doing business in Tennessee. Corporation X is in the process of designing a legal structure that will enable eligible businesses (Business Entities or Business Entity) located in Tennessee and doing business in Tennessee to participate in the financial performance of a portfolio of installment sales contracts (Receivables) originated by the Business Entities. The Business Entities are corporations that sell tangible personal property and finance purchases of such property for their customers. For each Business Entity that desires to participate, Corporation X plans to create a trust (Trust) organized under the Delaware Business Trust Statute. For purposes of this Revenue Ruling and Tennessee franchise, excise taxes, it is to be assumed that each Trust is doing business in Tennessee.

Corporation X will be the administrator of each Trust. Each trust agreement will be between Corporation X and the trustee who is a Delaware banking corporation. A Business Entity will be offered an opportunity to transfer to the Trust loans that it originates along with a cash capital contribution. In return, the Business Entity will be given a certificate in the Trust. The certificate will represent the following:

1. A 100% beneficial interest in the Business Entity's portfolio of Receivables periodically sold to the Trust.

2. Any cash capital contribution made to the Trust by the certificate holder.
3. The right to receive equity distributions from retained earnings with respect to the Receivables transferred to the Trust by the certificate holder.

A Trust will borrow money from Corporation X so that it may purchase the transferred loans from a certificate holder Business Entity. Although Corporation X will not hold any certificates in the Trust, Corporation X will be appointed as the administrative agent of the Trust. In this capacity, Corporation X will collect principal and interest from the original obligor on the loan and use these funds for the following purposes:

1. Pay a service fee for the management of the loan portfolio.
2. Pay interest on the loan extended to the Trust.
3. Periodically pay the certificate holders a return on their investments.

Neither Corporation X nor the Business Entities holding certificates in the Trusts are financial institutions for Tennessee franchise, excise tax purposes.

Under Tres. Reg. § 301.7701-3(a) (1997), better known as “check the box” regulations, each Trust will be disregarded as a separate entity for federal tax purposes and will be considered a division of the Business Entity that is its sole certificate holder. Consequently, a Trust will not have a federal identification number and will not file a federal tax return of any type, informational or otherwise.

QUESTIONS PRESENTED

1. For Tennessee franchise, excise tax purposes, will each Trust be disregarded as a separate entity and considered a division of the corporation that is its certificate holder?
2. If each Trust is treated as an entity separate from its certificate holder, how will it compute its franchise, excise tax liability?

RULING

1. No.
2. Each Trust will compute its franchise tax liability on the greater of its net worth (assets minus liabilities) or the book value (cost less accumulated depreciation) of its real or tangible personal property owned or used in Tennessee. Reserves and allocations of surplus that do not

represent definite and accrued legal liabilities or proper reductions in asset accounts must be included in the net worth franchise tax base. The excise tax liability of each Trust will be computed using the Trust's pro forma federal taxable income before net operating loss deductions and special deductions that the Trust would have had if it had been filing on a separate entity basis for federal income tax purposes. T.C.A. § 67-4-805 requires certain additions to and deductions from federal taxable income to compute the excise tax base. A Trust doing business both within and without Tennessee may apportion its net worth and net earnings in accordance with applicable apportionment statutes.

ANALYSIS

1. For Franchise, Excise Tax Purposes,
Each Trust Is Separate And Independent Entity From Its
Certificate Holder

T.C.A. §§ 67-4-806 and 67-4-903 impose franchise, excise taxes on "All corporations, cooperatives, joint-stock associations and business trusts, including regulated investment companies and real estate investment trusts, organized for profit . . . and doing business in Tennessee . . .". Business Entities that are owners and certificate holders in Trusts are individual and separate entities from the Trusts. Each Business Entity exists as a result of its state charter. Each Trust exists under the Delaware Business Trust Statute pursuant to a trust agreement between Corporation X and the trustee, a Delaware banking corporation. However, under the "check the box" provisions of Tres. Reg. § 301.7701-3(a) (1997), the Internal Revenue Service will consider each Trust to be a division of the Business Entity that is its certificate holder.

Although, under T.C.A. § 67-4-805(a), the starting point for determining net earnings for Tennessee excise tax purposes is federal taxable income before the net operating loss deduction and special deductions, nothing in Tennessee's franchise, excise tax statutes (T.C.A. §§ 67-4-801 et seq. and 67-4-901 et seq.) require or permit the use of the federal classification of a business for franchise, excise tax purposes.¹

With the exception noted in footnote 1, T.C.A. §§ 67-4-806 and 67-4-903 are applied to the entities named therein in accordance with the way such entities are legally classified without regard to how they may be classified for federal income tax purposes.

¹ T.C.A. § 48-211-101 does require the federal income tax classification of a Limited Liability Company to be followed for all state and local tax purposes, including the franchise, excise tax. However, this is the sole instance in which the federal income tax classification of a business entity is required or permitted for franchise, excise tax purposes.

Each Business Entity that is a certificate holder in a Trust is a separate legal corporate entity and each Trust is a separate legal trust organized under the Delaware Business Trust Statute. Thus, for Tennessee franchise, excise tax purposes, each Business Entity must be classified as a corporation and each Trust must be classified as a trust. Each Business Entity and each Trust is treated as a separate legal entity for purposes of Tennessee's franchise, excise taxes.

2. Computation Of A Trust's Franchise Tax And Excise Tax Bases

Since each Trust is doing business in Tennessee, it will be subject to Tennessee franchise excise taxes under T.C.A. §§ 67-4-903 and 67-4-806.

TENN. COMP. R. & REGS. 1320-6-1-.02(2) requires franchise, excise tax returns to be filed to coincide with each accounting period for which a federal return has been filed. *DAACO, Inc. v. Huddleston*, 891 S.W.2d 920 (Tenn. App. 1994), permission to appeal denied by Supreme Court 1-30-95. For federal income tax purposes, each Trust is considered to be a division of the corporation that is its certificate holder. However, for Tennessee franchise, excise tax purposes, each Trust is a separate business entity and must file its franchise, excise tax return to coincide with the accounting period for which it would have filed its federal return had it been required to file on a separate entity basis with the Internal Revenue Service.

Franchise Tax Base.

T.C.A. § 67-4-904 imposes the franchise tax on “. . . issued and outstanding stock, surplus and undivided profits . . . as shown by the books and records . . . at the close of its last fiscal year. A question arises with regard to the application of this statute to a Trust which has no “issued and outstanding stock”.

Questions involving statutory construction must be answered in the light of reason, keeping in mind the object of the statute. *State v. Williams*, 854 S.W.2d 904 at 908 (Tenn. Cr. App. 1993) citing *State v. Netto*, 486 S.W.2d 725 at 728 (Tenn. 1972). It is an accepted rule of statutory interpretation to presume that, in enacting a provision, the legislature did not intend an absurdity, and that such a result must be avoided, if possible, by reasonable construction of the statute. *State v. Harrison*, 692 S.W.2d 29 at 31 (Tenn. Cr. App. 1985), citing *Epstein v. State*, 366 S.W.2d 914 (Tenn. 1963).

No statutory interpretation will be adopted that defeats the purpose of the law, provided the language of the statute will admit, fairly and rationally, an interpretation which sustains that purpose. 23 Tenn. Juris., *Statutes*, § 36 (1985). In the event a statute is capable of more than one construction, it should be construed so as to effect, rather than defeat, its purpose. *Knox County, ex rel. Kessel v. Personnel Board*, 753 S.W.2d 357 (Tenn. App. 1988) citing *State v. Netto*, 486 S.W.2d 725 (Tenn. 1972).

The obligation to pay taxes arises only by force of legislative action and the nature and extent of that is determined by the legislative meaning. Therefore, all rules of statutory construction are relevant in the interpretation of revenue measures. C. Sands, *Sutherland Statutory Construction* § 66.03 (4th ed. vol. 3 1974). However, the rule of statutory construction to which all others must yield is that the intent of the legislature must prevail. *Southern v. Beeler et al.*, 195 S.W.2d. 857 at 864 (Tenn. 1946).

T.C.A. § 67-4-903 clearly subjects business trusts doing business in Tennessee to the franchise tax. The apparent legislative intent of T.C.A. § 67-4-904 is to impose the franchise tax on the net worth of a business subject to the tax, regardless of what the accounts that comprise its net worth are called. To read the statute otherwise would defeat its purpose and work an absurdity. Obviously, the legislature did not intend to impose the franchise tax on business trusts in T.C.A. § 67-4-903 and then, in T.C.A. § 67-4-904, make it impossible for a business trust to have a net worth franchise tax base.

The net worth of a business is defined as the amount by which its assets exceed its liabilities or the remainder after deduction of liabilities from assets. BLACKS LAW DICTIONARY 1041 (6th ed. 1990). It has been the Department of Revenue's long-standing position that the term "books and records" used in Tennessee's franchise tax statutes means books and records kept in accordance with Generally Accepted Accounting Principles.

Accordingly, under T.C.A. § 67-4-904, the franchise tax base of each Trust will be its net worth (assets minus liabilities) as shown by its books and records kept in accordance with Generally Accepted Accounting Principles. Reserves and allocations of surplus that do not represent definite and accrued legal liabilities or proper reductions in asset accounts must be included in the franchise tax base in accordance with TENN. COMP. R. & REGS. 1320-6-1-.16. In the event that a Trust is doing business both within and without Tennessee, its net worth may be apportioned in accordance with T.C.A. § 67-4-910 to determine its franchise tax base.

Notwithstanding T.C.A. § 67-4-904, T.C.A. § 67-4-906 provides that the franchise tax base of a business shall, in no case, be less than the book value (cost less accumulated depreciation) of its real and tangible personal property owned or used in Tennessee.

Thus, if the book value of a Trust's real or tangible personal property shown on its books and records kept in accordance with Generally Accepted Accounting Principles and owned or used in Tennessee under T.C.A. § 67-4-906 exceeds its net worth under T.C.A. § 67-4-904, the property values computed in accordance with T.C.A. § 67-4-906 will serve as the franchise tax base of such Trust.

Excise Tax Base.

Under T.C.A. § 67-4-805, the excise tax base of a business is its federal taxable income before the net operating loss deduction and special deductions with certain specified items being added to, or deducted from, such federal net earnings for purposes of determining the excise tax base.

For federal income tax filing purposes, a Trust is considered to be a division of its corporate certificate holder. However, under T.C.A. § 67-4-805(a), the starting point for computing each Trust's net earnings for excise tax purposes is the pro forma federal taxable income before net operating loss deductions and special deductions that the Trust would have had if it had been filing on a separate entity basis for federal income tax purposes.

Any specific items enumerated in T.C.A. § 67-4-805(b)(1) will be added to the pro forma federal taxable income of the Trust and specific items enumerated in T.C.A. § 67-4-805(b)(2) will be deducted from its pro forma federal taxable income to obtain the excise tax base. In the event that a Trust is doing business in Tennessee, it may apportion its net earnings for excise tax purposes in accordance with the provisions of T.C.A. § 67-4-811.

Arnold B. Clapp, Senior Tax Counsel

APPROVED:

Ruth E. Johnson, Commissioner

DATE: 7-28-98